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Supreme Court, U.S.
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No. 10-407

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In The Supreme Court of the United States

ANTHONY GOULD,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

The Ninth Circuit affirmed a decision of its Bankruptcy Appellate Panel, holding there was no requirement to object to a Debtor's claim of exempt property within 30 days by a creditor asserting a right of setoff, because there was no value to the claimed amount. This is a ripe corollary case to this court's recent decision in *Schwab v. Reilly*, 130 S. Ct. 2652, 177 L. Ed. 2d 234 (2010) impacting the important Debtor's right to exempt property. Because of the different approaches taken by the Fifth and Second Circuits; the three-way split in the lower court decisions and a need for uniform application of the Court's decision in *Taylor v. Freeland & Kronz*, 503 U.S. 638, 112 S. Ct. 1644, 118 L. Ed. 2d 180 (1992), two questions are presented:

1. Whether a Debtor's allowed exemption pursuant to 11 U.S.C. §522 is superior to and trumps a creditor's setoff rights under 11 U.S.C. §553 absent timely objection to the claimed exemption.

2. Whether a creditor's setoff request pursuant to 11 U.S.C. §553 is moot when mutuality of debt is absent.

LIST OF PARTIES

The name of the Petitioner is:
Anthony Gould

The name of the Respondent is:
United States of America

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PETITION FOR WRIT OF CERTIORARI

Petitioner, Anthony Gould, petitions the Court for a Writ of Certiorari to review a final judgment of the United States Court of Appeals for the Ninth Circuit, (entered June 22, 2010) affirming the Bankruptcy Appellate Panel of the Ninth Circuit's reversal of the bankruptcy court's decision denying relief from stay to setoff funds duly exempted by Debtor.

OPINIONS BELOW

The opinion of the U.S. Bankruptcy Court for the Northern District of California, dated June 12, 2008, is officially reported as *In re Gould,* 389 B.R. 105 (Bankr. N.D. Cal. 2008) and is reproduced at Appendix ("App.") 40-97. The opinion of the Bankruptcy Appellate Panel of the U.S. Court of Appeals for the Ninth Circuit, dated February 11, 2009 is officially reported as *United States v. Gould* (*In re Gould*), 401 B.R. 415 (B.A.P. 9th Cir. 2009) and is reproduced at App. 6-39. The opinion of the U.S. Court of Appeals for the Ninth Circuit (O'Scannlain, Trott & Paez, J.J.) is officially reported as *Gould v. United States,* 603 F. 3d 1100 (9th Cir. 2010) and is reproduced at App. 1-4. The denial of rehearing en banc of the United States Court of Appeals for the Ninth Circuit is reported and is included at App. 98.

STATEMENT OF JURISDICTION

The judgment of the U.S. Court of Appeals for the Ninth Circuit sought to be reviewed was entered on April 30, 2010. The Order Denying Rehearing en banc was entered on June 22, 2010. The petition is timely under 28 U.S.C. §2102(c) and Supreme Court Rules 13.1 and 13.3 because it is being filed within 90 days after the denial of a timely petition for rehearing. The Court has jurisdiction to review the judgment of the U.S. Court of Appeals for the Ninth Circuit pursuant to 28 U.S.C. §1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Article III Section 2 of the United States Constitution

The judicial power shall extend to all cases . . . (and) . . . to controversies . . .

11 U.S.C. §522(l) The Debtor shall file a list of property that the Debtor claims as exempt under subsection (b) of this section. . . . Unless a party in interest objects, the property claimed on such list is exempt.

11 U.S.C. §553(a) Except as otherwise provided in this section and Sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the Debtor that arose before the commencement of the

case under this title against a claim of such creditor against the Debtor that arose before the commencement of the case . . .

11 U.S.C. §362 . . . a petition filed under .this title operates as a stay, applicable to all entities, of –

(7) the setoff of any debt owing to the Debtor that arose before the commencement of the case under this title against any claim of the Debtor . . .

26 U.S.C. §6402(a) In the case of an overpayment, the Secretary within the applicable time period, may credit the amount of such overpayment, including any interest thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment, and shall . . . refund any balance to such person.

STATEMENT OF THE CASE

Petitioner, Anthony S. Gould was the Debtor in a Chapter 13 bankruptcy proceeding, filed on January 20, 2005. The United States (Internal Revenue Service) objected to confirmation of Debtor's plan because of Debtor's failure to file tax returns for years 1999-2004. Debtor filed the returns and on May 26, 2005 filed Amended Schedules B & C, exempting refunds in the total amount of $11,047. It was later agreed that the amount was incorrect and based upon an Amended return for one year the actual amount exempted was $6,852.

On October 5, 2005, the Debtor's Amended Plan was confirmed. The IRS filed a Motion For Relief From Stay on October 25, 2005 to setoff pre-petition tax liabilities against the Debtor's post-petition refunds. Debtor opposed the Motion on the basis that the claimed refund was duly exempted by the Amended Schedule C filed with the Court on May 26, 2005 to which there was no opposition within the thirty-day deadline. On July 10, 2006, the IRS amended its proof of claim, the first claim to provide for a secured claim "pursuant to right of setoff".

The Bankruptcy Court denied the Motion For Relief to setoff and ordered the exempted funds in the amount of $6,852 to be turned over to the Debtor.

The Bankruptcy Court concluded that the IRS's failure to object to Debtor's exemption triggered consequences of this Court's decision in *Taylor v. Freeland & Kronz,* 503 U.S. 638, 112 S. Ct. 1644, 118 L. Ed. 2d 180 (1992) which held that a party is barred from contesting the validity of an exemption after the thirty-day deadline to object set forth in Rule 4003 expires, regardless of whether the Debtor had a colorable statutory basis for claiming it. The Bankruptcy Court held that once claimed exempt, they no longer were subject to setoff. Accordingly, the Motion For Relief From Stay was denied. As an alternative reason for denying the IRS's motion, the court exercised its equitable discretion to disallow the IRS's setoff rights.

The IRS filed a Motion to stay the order pending appeal but the Motion was denied at the hearing as

moot when it became apparent the funds had already been returned to the Debtor. The return of funds occurred before the IRS filed its Notice of Appeal to the Bankruptcy Appellate Panel.

Upon appeal, the decision was reversed and remanded by the Bankruptcy Appellate Panel of the Ninth Circuit, (Jury, Markell & Dunn, J.J.). The Bankruptcy Appellate Panel's decision held that although the funds were turned over to Debtor by the IRS, the setoff request pursuant to 11 U.S.C. §553 was not moot although mutuality of debt was now absent. The B.A.P. held the IRS's setoff rights were preserved under §553 and that no cause existed for relief from stay. The bankruptcy court's alternate holding denying setoff on equitable grounds was reversed for abuse of discretion for disregarding the distinct terms under which the IRS can exercise setoff. The B.A.P. questioned whether the exemption held any weight when a federal statute, the IRC §6402 controls the IRS's setoff rights. The B.A.P. also stated that the federal statute does not recognize state exemptions and stated that the Supremacy Clause would prevent state exemption laws from defeating federal setoff rights.

The Court of Appeals for the Ninth Circuit (O'Scannlain, Trott & Paez, J.J.), summarily adopted the decision of the Bankruptcy Appellate Panel. Debtor's subsequent request for rehearing en banc was denied.

REASONS FOR GRANTING THE PETITION

The Ninth Circuit opinion headily impacts the delicate balance of rights of Debtors and creditors as contemplated by the Bankruptcy Code and the case represents an important ripe companion case to this Court's recent decision in *Schwab v. Reilly,* 130 S. Ct. 2652, 177 L. Ed. 2d 234 (2010). The decision also mars the uniform application of this Court's decision in *Taylor v. Freeland & Kronz,* 503 U.S. 638 (1992) since it may be deemed to excuse all creditors with a right to setoff from objecting to Debtors claimed exemptions.

By this decision the dollar amount specified to be exempted by Debtor was deemed to be zero, absent any notice or objection to the claimed exemption by the very party who was uniquely positioned to contest the valuation of the funds sought to be exempted. Since all setoff claims of creditors may impact a contingent claim exempted by a Debtor, the preservation of the requirement to timely object to a claimed exemption is an issue of importance.

The IRS Motion was for relief from stay to setoff funds. It must be noted that setoff is permissive rather than mandatory and the decision ultimately rests within the discretion of the Court. *In re Cascade Roads, Inc.,* 34 F. 3d 756, 763 (9th Cir. 1994). Likewise, relief from stay is granted at the discretion of the court on a case by case basis upon a balancing of the equities. See *Christensen v. Tucson Estates, Inc.* 912 F. 2d 1162 (9th Cir. 1990).

As a further preliminary matter, it is well established that unliquidated claims for tax refunds for pre-petition taxable years are included within the property of the estate. *Kokoska v. Belford,* 417 U.S. 642, 648, 94 S. Ct. 2431, 2435, 41 L. Ed. 2d 374 (1974); *Mueller v. Commissioner,* 496 F. 2d 899, 903 (5th Cir. 1974); *In re Barowsky,* 946 F. 2d 1516 (10th Cir. 1991). It is therefore recognized that the funds belong to the Debtor. Debtor exempted this property under C.C.P. §703.140(b)(5), which closely mirrors Bankruptcy Code §522(d)(5). No objection was made to the exemption within the 30 day deadline provided in Bankruptcy Rule 4003(b). As this Court has stated, "an exemption is an interest withdrawn from the estate (and hence from the creditors) for the benefit of the debtor". *Owen v. Owen,* 500 U.S. 305, 308, 111 S. Ct. 1833, 114 L. Ed. 2d 350 (1991).

I. Review is warranted to determine the preferred approach between the Second Circuit Court of Appeals decision favored by the bankruptcy judge (*In re Chateaugay*) and the Circuit case from the Fifth Circuit (*In re Luongo*) adopted by the Bankruptcy Appellate Panel (B.A.P.) whose decision was affirmed.

The B.A.P. decision affirmed by the Ninth Circuit adopted the IRS argument that there was no requirement to object to the Debtor's exemptions since there was nothing remaining for the Debtor to exempt after the IRS performed its "accounting

procedure" under 28 U.S.C. §6402(a) and determined that no refund existed to exempt. The B.A.P. held the contingent claim was property of the estate with a value at zero; relying primarily on the Fifth Circuit decision in *Internal Revenue Service v. Luongo* (*In re Luongo*), 259 F. 3d 323 (5th Cir. 2001) and citing the Seventh Circuit in *Pettibone Corp. v. United States,* 34 F. 3d 536 (7th Cir. 1994) and the Ninth Circuit decision in *Carolco Television, Inc. v. Nat'l Broad. Co.* (*In re De Laurentiis Entertainment Group, Inc.*), 963 F. 2d 1269 (9th Cir. 1992) in support.

The B.A.P. cited *De Laurentiis* for the proposition that since its origins in Roman law and common law, setoffs in bankruptcy have been generally favored (App. 20) and following its statement that the language of §553 which read "this title does not affect the right of a creditor to offset a mutual debt" meant that "notwithstanding any other provision of the Bankruptcy Code", this should be so, since to hold otherwise would nullify §553 and ignore its plain language. (App. 29).

The Second Circuit in *Aetna Casualty and Surety Co. v. LTV Steel Co., Inc.* (*In re Chateaugay Corp.*), 94 F. 3d 772 (2nd Cir. 1996), however unequivocally held that the "netting" of an overpayment to extinguish an "underpayment" is itself classic setoff within the meaning of the Bankruptcy Code, subject to the provisions of §362 and §553. The *Chateaugay* court held:

"By arguing the accounting procedure under §6402(a) is something other than an ordinary right of setoff, the government in essence asks us to find that the bankruptcy laws do not apply to the IRS. This we cannot do. For the Supreme Court has quite clearly held that '[n]othing in the Bankruptcy Code or the legislative history indicates that Congress intended a special exception for the tax collector.' *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 209, 103 S. Ct. 2309, 2316, 76 L. Ed. 2d 515 (1983); see also *United States ex rel. IRS v. Norton,* 717 F. 2d 767, 772 (3d Cir. 1983)" *Chateaugay,* 94 F. 3d at 780-81. The Court therefore held that there was a common law right to offset LTV Steel's black lung liabilities against the company's tax refund and that that right was prior to any right of the IRS to offset post-petition tax liabilities against pre-petition overpayments.

The B.A.P. decision, affirmed by the Ninth Circuit followed *Internal Revenue Service v. Luongo* (*In re Luongo*), 259 F. 3d 323 (5th Cir. 2001) and relied heavily on the distinction between an "overpayment" from a "refund". In *Luongo,* the Court noted

> Section 6402(a) grants the IRS discretion whether to offset a Debtor's unpaid tax liability or to refund the overpayment to the taxpayer. Because the prior unpaid tax liability exceeded the amount of the overpayment, the Debtor was not entitled to a refund and the tax refund did not become property of the estate. Absent an interest in the estate to the refund, it could not properly be exempted by the Debtor under §522.

Id. at 335.

With this analysis however, as the bankruptcy court reasoned, there would accordingly be no property the Debtor had for the IRS to setoff (no mutuality of debt), and the claim for setoff would fail. Nothing to exempt, nothing to setoff.

In addition, the *Luongo* facts were crucially different and guidance is required to avoid further misapplication of the case. In *Luongo,* the IRS setoff the pre-petition tax liability against the pre-petition tax refund *before* the Debtor reopened her bankruptcy case and amended her schedules to claim the tax refund as exempt. The Fifth Circuit held that because the IRS had elected to set off the tax liability, there was no longer a balance to be refunded to the Debtor. Since the setoff occurred *prior* to the claim of exemption, *Taylor* was not controlling. The Fifth Circuit decision specifically states that it did not reach the exemption issue decided below – that is whether Section 522(c) prevents a creditor from exercising its rights of setoff preserved in §553". *Luongo,* 259 F. 3d at 328. Therefore it is inaccurate to cite the decision to stand for the proposition that because of the netting allowed by IRC §6402(a), the IRS's setoff claim under §553 trumps an exemption asserted by the Debtor, without opposition, under §522.

II. Review is warranted to resolve the three-way split among lower court decisions determining the issue as to whether IRS setoff rights trump a Debtor's right to exempt tax refunds.

Among the lower courts, there is a three-way split of authority on the issue. The first line of cases, considered the majority view at least until 2001 holds setoff cannot be made against assets exempted under §522 to protect Debtor's fresh start. *In re Sharp,* 286 B.R. 627, 629 (Bankr. E.D. Ky. 2002); *In re Pace,* 257 B.R. 918, 920 (Bankr. W.D. Mo. 2000); *In re Jones,* 230 B.R. 875, 880 (M.D. Ala. 1999); *In re Alexander,* 225 B.R. 145, 149 (Bankr. W.D. Ky. 1998); *In re Monteith,* 23 B.R. 601 (Bankr. N.D. Ohio 1982); *In re Tubbs,* No. 99-33506-PB7, 2000 WL 1203508, at *1 (Bankr. S.D. Cal. 2000). See also, *In re Tarbuck,* 318 B.R. 78 (Bankr. W.D. PA. 2004); *In re Killen,* 249 B.R. 585 (Bankr. D. Conn. 2000) and *In re Haffner,* 12 B.R. 371 (Bankr. M.D. Tenn. 1981).

The second line of cases holds that setoff rights always prevail over an exemption under §522 relying on those courts' reading of various sections of the Bankruptcy Code. *Internal Revenue Service v. White,* 365 B.R. 457 (M.D. Pa. 2007); *United States v. Luongo,* 255 B.R. 424 (N.D. Tex. 2000), *aff'd on different grounds,* 259 F. 3d 323 (5th Cir. 2001); *In re Martinez,* 258 B.R. 364 (Bankr. W.D. Tex. 2000); *In re Glenn,* 2000 WL 33364195 (Bankr. W.D. Wis. 2000); *Posey v. IRS,* 156 B.R. 910 (W.D. N.Y. 1993); *In re Eggemeyer,* 75 B.R. 20 (Bankr. S.D. Ill. 1987).

See also, *In re Junio,* 2002 WL 32001412 (E.D. N.Y. 2002); *In re Bourne,* 262 B.R. 745 (Bankr. E.D. Tenn. 2001); *In re Wiegand,* 199 B.R. 639 (W.D. Mich. 1996).

The third line of cases, followed by the Ninth Circuit here, holds that a Debtor's estate has no interest in any tax "overpayment" – and therefore, the Debtor cannot claim any amount as exempt – until the IRS has determined that a refund is owing after "netting" the tax liabilities pursuant to IRC §6402(a). *Pettibone v. United States,* 34 F. 3d 536 (7th Cir. 1994); *IRS v. Luongo (In re Luongo*), 259 F. 3d 323 (5th Cir. 2001); *United States v. Midway Indus. Contractors, Inc.* (*In re Midway Indus. Contractors, Inc.*),178 B.R. 734 (N.D. Ill, 1995); *Lyle v. Santa Clara Co. Dept. of Child Support* (*In re Lyle*), 324 B.R. 128 (Bankr. N.D. Cal. 2005); *Security Pac. Nat'l Bank v. U.S.* (*In re Siebert Trailers*), 132 B.R. 37 (Bankr. E.D. Cal. 1991); *In re Baucom,* 339 B.R. 504 (Bankr. W.D. Mo. 2006); *Beaucage v. IRS,* 342 B.R. 408 (D. Mass. 2006); *In re Jones,* 359 B.R. 837 (Bankr. M.D. Ga. 2006); *In re Shortt,* 277 B.R. 683 (Bankr. N.D. Tex. 2002); *In re Pigott,* 330 B.R. 797 (Bankr. S.D. Ala. 2005).

Most recently, in *Miller v. U.S.*, 422 B.R. 168 (W.D. Wis. 2010) the Debtor appears to have listed the item exempted an "overpayment" but the court found setoff rights nevertheless prevailed.

Review is warranted to determine the best approach reconciling all legal concepts involved. The approach adopted by the bankruptcy court gives

meaning to both §§522 and 553 and recognizes that all contingent, unliquidated assets are property of the estate, that funds overpaid to the IRS do belong to the Debtor, that Debtor has an asset to exempt which absent timely objection to the claimed exemption, makes setoff, which is permissive and not mandatory, unavailable. The approach also ensures that an exception is not carved out for the IRS from compliance with §522(l) and Federal Rule of Bankruptcy Procedure 4003(b).

Review is essential to preserve every Debtor's primal right to his exempt property. The funds ceased to be property of the estate when the Debtor exempted them, without opposition by the IRS. To allow the decision to stand in effect permits the dollar amount statutorily available for exemption by Debtor to be reduced to zero by a creditor absent any notice to the Debtor. The act of listing property as exempt must bear value. The requirement for timely objection to the claimed exemption must not be waived for IRS or other creditors with setoff rights. To waive this requirement costs the Debtor his fresh start. Recently, this court in *Schwab v. Reilly, supra,* certainly upheld the Debtor's right to the stated value on her schedules and did not contemplate not allowing Debtor to retain at least the exempted amount of $10,718 of her equipment or proceeds from sale of same.

Upon determination of the preferred approach, the bankruptcy court's alternate holding denying relief from stay to setoff on equitable grounds may

also not have been an abuse of discretion stemming from an erroneous application of the law.

III. Review is warranted because the issue as to whether exemption claims trump setoff claims absent timely objection remains unresolved by the change in the law for cases filed after October 17, 2005 by the addition of Bankruptcy Code §362(b)(26) which merely provides that the setoff by the IRS of a pre-petition tax refund is not stayed.

Section 362(b)(26) was added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 199 Stat. 23 §418 (Apr. 20, 2005). While this provision eliminates the need for the IRS to bring a Motion For Relief From Stay, to exercise its rights under 6402(a), it does *not* resolve the issue of whether the IRS may setoff against tax refunds when the Debtor has exempted such funds under §522, absent timely objection. This remains a very live issue.

Furthermore, no additional legislative change or amendment was made in the Act to clarify this issue. It must be noted that this case at bar, was filed before the provision was effective, and thus the IRS was required to obtain relief from stay which is always at the discretion of the court.

It is quite telling, however, that the provision was added. Its need and enactment boldly spells and

underlines the plausible error of the Ninth Circuit's approach prayed for review.

Also of note is that there was no change to §522(l) and Bankruptcy Rule 4003(b) for cases filed after October 17, 2005.

IV. Review is warranted because of conflict between the Ninth Circuit decision and the Bankruptcy Appellate Panel's decision in the Eighth Circuit regarding mootness of the request for setoff once the IRS released the disputed funds to Debtor.

Exercise of judicial power depends on the existence of a case or controversy pursuant to Article III of the Constitution. *De Funis v. Odegard,* 416 U.S. 312, 316 94 S. Ct. 1704, 40 L. Ed. 2d 164 (1974). Subsequent to the entry of the bankruptcy court's Order denying relief from stay and before the Notice of Appeal to the B.A.P. was filed by the IRS, the IRS gave the Debtor the $6,852 at issue.

Setoff requires mutuality of debt and is designed to avoid "the absurdity of making A pay B when B owes A". *Citizen's Bank of Md. v. Strumpf,* 516 U.S. 16, 18 (1995), quoting *Studley v. Boylston National Bank,* 229 U.S. 523, 528 (1913). Therefore at issue, is whether the release of funds was a fatal misstep barring relief. The Ninth Circuit held it did not. However, the decision is in conflict with an Eighth Circuit B.A.P. decision, *Internal Revenue Service v.*

Ealy (In re Ealy), 396 B.R. 20 (B.A.P. 8th Cir. 2008) which is directly on point.

In *Ealy,* the IRS moved for relief from stay to permit offset of the Debtor's tax overpayment and economic stimulus payment under the Economic Stimulus Act of 2008 against his post-petition tax liability. The bankruptcy court denied the IRS's Motion, concluding the IRS was adequately protected by the Debtor's confirmed plan, which provided for periodic payments in full of the Debtor's post-petition tax liability. The IRS appealed and sought a stay of the order pending appeal from the bankruptcy court. The bankruptcy court denied its request. The IRS paid the overpayment and stimulus payment to the Debtor. The IRS appealed the bankruptcy court's order denying relief from stay. The Eighth Circuit correctly concluded that the IRS no longer had a right of setoff because the mutuality aspect of §553 had been lost because of the IRS's payment to the Debtor. Therefore the court held that even if it did reverse the bankruptcy court, it was impossible to grant meaningful relief, since the IRS had only sought relief from stay to effectuate setoff rights.

The Ninth Circuit rejected the mootness argument in *Ealy*, declaring it nonbinding and contrary to the more expansive Ninth Circuit rule regarding mootness. It especially found that the appeal is not moot because (1) the appellate court had power to fashion effective relief by ordering the Debtor to return the money; (2) Debtor was a party to the appeal; (3) because the taxpayer's present inability to

make restitution for an erroneously paid refund, nor mistake by the IRS issuing the erroneous refund, excused the taxpayer's legal obligation to repay the refund; and (4) there was no requirement for the appellate court to return the parties to the *status quo ante*. (App. 14-19).

Returning to the "netting" argument discussed above, this approach is also at the cost of mutuality of debt, because if the claim is valued at zero, there is accordingly nothing to setoff.

Petitioner also challenges the Ninth Circuit's denial of the application to dismiss the appeal for lack of jurisdiction based upon equitable mootness which was offered to the Ninth Circuit. By the time the B.A.P. decision was made, the Debtor had completed his payments due under the confirmed Chapter 13 plan; immediate restitution may not have been possible by the Debtor to the IRS and since the IRS failed to object to the claimed exemptions, took quite some time to file their Motion and secured proof of claim, the equities favor the Debtor and his fresh start. "Ultimately, the decision whether to unscramble the eggs turns on what is practical and equitable." *Baker & Drake, Inc. v. Public Ser. Comm'n (In re Baker & Drake, Inc.)*, 35 F. 3d 1348, 1352 (9th Cir. 1994).

Here, in the totality of circumstances, the case should have been legally and equitably moot, especially because "setoff is a solely defensive posture, it cannot be used in an aggressive manner to deprive a Debtor of the fresh start contemplated by the Code.

Pieri v. Lysenko (In re Pieri), 86 B.R. 208 at 213 (citations omitted) (B.A.P. 9th Cir. 1988).

CONCLUSION

For all the foregoing reasons, Petitioner respectfully requests that the Supreme Court grant review of this matter.

Respectfully submitted,

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FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re: ANTHONY S. GOULD, *Debtor*, ANTHONY S. GOULD, *Appellant*, v. UNITED STATES OF AMERICA, *Appellee*, and DEVIN DERHAM-BURK, Chapter 13; UNITED STATES TRUSTEE, *Trustees*.	No. 09-60008 BAP No. NC-08-1100-JuMkD ORDER

Appeal from the Ninth Circuit
Bankruptcy Appellate Panel
Markell, Dunn, and Jury,
Bankruptcy Judges, Presiding

Argued and Submitted
February 9, 2010 – San Francisco, California

Filed April 30, 2010

Before: Diarmuid F. O'Scannlain, Stephen S. Trott and Richard A. Paez, Circuit Judges.

COUNSEL

David A. Boone and Leela V. Menon, Law Offices of David A. Boone, San Jose, California, for the appellant.

Randolph L. Hutter, Department of Justice, Tax Division, Washington D.C., for the appellee.

ORDER

The published order filed April 19, 2010, is hereby WITHDRAWN.

ORDER

The central issue in this case is whether or not the Bankruptcy Court erred in denying the government's motion to lift the automatic stay to allow the Internal Revenue Service "IRS" to offset the debtor's income tax overpayment against his outstanding federal income tax liabilities pursuant to 11 U.S.C. § 553 and 26 U.S.C. § 6402(a). For the reasons given by our Bankruptcy Appellate Panel in *In re Gould*, 401 B.R. 415 (B.A.P. 9th Cir. 2009), we reverse the decision of the Bankruptcy Court, *In re Gould*, 389 B.R. 105 (Bankr. N.D. Cal. 2008), and remand for further proceedings. We note that for cases filed after October 17, 2005, 11 U.S.C. § 362(b)(26) permits the IRS to setoff a pre-petition income tax overpayment against a pre-petition income tax liability without seeking relief from the automatic stay.

Accordingly, the judgment of the Bankruptcy Appellate Panel is AFFIRMED.

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re: ANTHONY S. GOULD, *Debtor,* ANTHONY S. GOULD, *Appellant,* v. UNITED STATES OF AMERICA, *Appellee,* and DEVIN DERHAM-BURK, Chapter 13; UNITED STATES TRUSTEE, *Trustees.*	No. 09-60008 BAP No. NC-08-1100-JuMkD ORDER

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COUNSEL

David A. Boone and Leela V. Menon, Law Offices of David A. Boone, San Jose, California, for the appellant.

Randolph L. Hutter, Department of Justice, Tax Division, Washington D.C., for the appellee.

ORDER

The central issue in this case is whether or not the Bankruptcy Court erred in denying the government's motion to lift the automatic stay to allow the Internal Revenue Service "IRS" to offset the debtor's income tax overpayment against his outstanding federal income tax liabilities pursuant to 11 U.S.C. § 553 and 26 U.S.C. § 6402(a). For the reasons given by our Bankruptcy Appellate Panel in *In re Gould,* 401 B.R. 415 (B.A.P. 9th Cir. 2009), we reverse the decision of the Bankruptcy Court, *In re Gould,* 389 B.R. 105 (Bankr. N.D. Cal. 2008), and remand for further proceedings. We note that for cases filed after October 17, 2005, 11 U.S.C. § 362(b)(26) permits the IRS to setoff a pre-petition income tax overpayment against a pre-petition income tax liability without seeking relief from the automatic stay.

REVERSED and REMANDED.

ORDERED PUBLISHED

UNITED STATES BANKRUPTCY APPELLATE PANEL OF THE NINTH CIRCUIT

In re: ANTHONY S. GOULD, Debtor,	BAP No. NC-08-1100-JuMkD Bk. No. 05-50292.
UNITED STATES OF AMERICA, Appellant, v. ANTHONY S. GOULD, Appellee.	**OPINION**

Argued and Submitted on November 20, 2008
at San Francisco, California

Filed – February 11, 2009

Appeal from the United States Bankruptcy Court
for the Northern District of California

Hon. Arthur S. Weissbrodt,
Bankruptcy Judge, Presiding.

Before: JURY, MARKELL and DUNN, Bankruptcy Judges.

JURY, Bankruptcy Judge:

The United States of America, on behalf of the IRS, appeals the bankruptcy court's order denying its motion for relief from stay.

The IRS sought relief from stay under § 362(d)(1) and (2)[1] in order to set off the prepetition tax payments of Anthony S. Gould ("Debtor") against his prepetition tax liabilities under 26 U.S.C. § 6402(a)[2] and § 553.

In a published decision, *In re Gould,* 389 B.R. 105 (Bankr. N.D. Cal. 2008), the bankruptcy court ultimately denied the IRS's motion based on its conclusion that the IRS could not establish a right of setoff under § 553 for two reasons. First, the bankruptcy court held that Debtor's allowed exemption in certain tax refunds was superior to the IRS's setoff rights under § 553. The court reasoned that the Supreme Court's holding in *Taylor v. Freeland & Kronz,* 503 U.S. 638 (1992), controlled because the IRS did not object to Debtor's exemption claim. Therefore, the

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[1] Unless otherwise indicated, all chapter, section and rule references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330, and to the Federal Rules of Bankruptcy Procedure, as enacted and promulgated prior to October 17, 2005, the effective date of most of the provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, April 20, 2005, 119 Stat. 23 ("BAPCPA"), as the debtor's case was filed in advance of the BAPCPA effective date.

[2] Citations to the Internal Revenue Code, 26 U.S.C. § 1 et seq. will be referred to as "IRC".

court determined that even if Debtor had no colorable basis for his claimed exemption, it was allowed and could no longer be challenged by the IRS through setoff.

Second, the bankruptcy court exercised its equitable discretion to disallow the IRS's setoff under § 553 even though (1) the IRS established that it had a right of setoff under IRC § 6402(a) and (2) the bankruptcy court had found the requirements of § 553 were met.

Because we hold that the bankruptcy court premised its ruling on an erroneous view of the law, we REVERSE for the reasons set forth below and REMAND for entry of an order consistent with this opinion.

I. FACTS[3]

The material facts relevant to this appeal are undisputed and raise two straightforward issues: (1) whether the IRS demonstrated the requisite cause for relief from the automatic stay under § 362(d)(1),[4]

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[3] Most of the facts are taken from the bankruptcy court's published decision, *Gould,* 389 B.R. 105.

[4] This subsection provides: "On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay – (1) for cause, including the lack of adequate protection of an interest in property of such party in interest;. . . ."

and (2) whether the IRS demonstrated that Debtor did not have equity in the tax refunds and whether they were necessary for an effective reorganization under § 362(d)(2).[5]

Debtor filed his petition, schedules and chapter 13 plan on January 20, 2005. The IRS filed its initial proof of claim against Debtor on February 24, 2005, which included estimated taxes due for 1999 to 2004.

On March 2, 2005, the IRS objected to the confirmation of Debtor's plan on the grounds that (1) the plan failed to provide for full payment of the IRS's priority claim and (2) Debtor's failure to file federal income tax returns for the years 1999-2004 made it difficult to determine the plan's feasibility. The confirmation hearing was continued so that Debtor could prepare and file his federal income tax returns and resolve the IRS's objections.

On May 26, 2005, Debtor filed an amended plan and amended Schedules B, C, D, and E. In his amended Schedule B, Debtor listed claims for federal income tax refunds for tax years 2002, 2003 and 2004. In his amended Schedule C, Debtor listed

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[5] This subsection provides: "On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay – . . . (2)with respect to a stay of an act against property under subsection (a) of this section, if – (A) the debtor does not have an equity in such property; and (B) such property is not necessary to an effective reorganization;. . . ."

federal income tax refunds for tax years 2002, 2003 and 2004 totaling $11,047[6], claimed exempt under Cal. Code Civ. Proc. ("CCP") § 703.140(b)(5).[7] No party objected to Debtor's exemptions.

Debtor's amended plan was confirmed on October 5, 2005, without objection.[8]

In June and July of 2005, Debtor filed his tax returns for the years 1999 to 2004. Subsequently, the IRS filed several amended proofs of claim; however, the only one relevant for purposes of this appeal is its fourth and final amended proof of claim ("Fourth Amended Claim") in the amount of $9,972.44 divided as follows: (1) secured – $6,852, based on the IRS's right to setoff under IRC § 6402(a); (2) unsecured

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[6] Debtor claimed refunds of $11,047, but subsequently acknowledged that the amount was $6,852. While the balances owing between the parties were unclear, they agreed that the IRS sought to set off $6,852.

[7] This section, known as the wildcard exemption, states that Debtor may exempt his "aggregate interest, not to exceed in value nine hundred twenty-five dollars ($925) plus any unused amount of the exemption provided under paragraph (1), in any property." Paragraph (b)(1) of CCP § 703.140 referred to in (b)(5) provides an exemption for Debtor's "aggregate interest, not to exceed seventeen thousand four hundred twenty-five dollars ($17,425) in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence. . . ." CCP § 703.140(b).

[8] Debtor's amended plan called for payments of $75 per month based on his excess income over expenses, which would pay approximately two percent to general unsecured claims over thirty-seven months.

priority – $307.51 and (3) general unsecured $2,812.93.

On October 25, 2005, the IRS filed its Motion for Relief from Stay to Set Off Tax Refund ("Motion"), which sought to apply the $6,852 that the IRS owed to Debtor against the $9,972.44 that Debtor owed the IRS. The IRS argued that (1) the tax refunds claimed by Debtor were not part of his bankruptcy estate because none were actually due and, therefore, Debtor was not entitled to exempt them; (2) setoff under § 553 was appropriate because the tax refunds due Debtor were for prepetition periods and his tax liabilities were for prepetition periods; and (3) its right of setoff under IRC § 6402(a) constituted cause for relief from the automatic stay.[9] Debtor objected to the relief sought on the ground that his claimed exemption in the tax refunds was allowed under § 522 and CCP § 703.104(b)(5) and, therefore, his exemption rights were superior to the IRS's setoff rights.

After protracted briefing and hearings, the bankruptcy court issued a Memorandum Decision on March 31, 2008, denying the IRS's Motion. The decision was amended on June 13, 2008, and published, *In re Gould,* 389 B.R. 105. The court viewed the primary issue to be whether the IRS's setoff should be allowed against property that Debtor had

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[9] However, throughout the briefing in this case, the IRS has argued, in the alternative, for relief from stay under either § 362(d)(1) or (2).

already fully exempted without challenge by the IRS or any other party. *Id.* at 111.

The bankruptcy court concluded that the IRS's failure to object to Debtor's exemption in the tax refunds triggered the consequences of the Supreme Court's decision in *Taylor,* 503 U.S. 638, which held that a party is barred from contesting the validity of an exemption after the thirty-day deadline to object set forth in Rule 4003 expires, regardless of whether Debtor had a colorable statutory basis for claiming it. The bankruptcy court held that once the tax refunds were deemed exempt, they no longer were subject to setoff. Accordingly, the court denied the IRS's motion for relief from stay.

As an alternative reason for denying the IRS's motion, the bankruptcy court exercised its equitable discretion to disallow the IRS's setoff rights under § 553 even though the IRS had established that it had a right of setoff under IRC § 6402(a) and all the requirements under § 553 were met.[10] *Gould,* 389 B.R. at 127-29.

The order denying the IRS's Motion and requiring the IRS to promptly pay Debtor $6,852 was entered on April 16, 2008.

The IRS filed a Motion to Alter or Amend Judgment or, in the Alternative for Stay of Order ("Motion

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[10] The court found the equities weighed in Debtor's favor as discussed *infra* in Section V(D).

for Stay"), which became moot after the IRS mistakenly paid Debtor pursuant to the court's order.

The IRS timely appealed.

II. JURISDICTION

The bankruptcy court had subject matter jurisdiction pursuant to 28 U.S.C. § 1334 over this core proceeding under § 157(b)(2)(G). We have jurisdiction under 28 U.S.C. § 158.

III. ISSUES

A. Whether the bankruptcy court abused its discretion by denying the IRS's motion for relief from stay under § 362(d)(1) and (2).

B. Whether the bankruptcy court abused its discretion in disallowing the IRS's setoff under § 553 based on the equities of the case.

IV. STANDARDS OF REVIEW

The decision to deny a motion for relief from stay and disallow a setoff is reviewed for abuse of discretion. *Arkinson v. Frontier Asset Mgmt., LLC (In re Skagit Pac. Corp.)*, 316 B.R. 330, 335 (9th Cir. BAP 2004); *United States v. Carey (In re Wade Cook Fin. Corp.)*, 375 B.R. 580, 588 (9th Cir. BAP 2007). "A bankruptcy court abuses its discretion if it bases its ruling on an erroneous view of the law." *Wade Cook*, 375 B.R. at 588.

We review the bankruptcy court's conclusions of law de novo, and factual findings for clear error. *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC),* 391 B.R. 25, 32 (9th Cir. BAP 2008).

V. DISCUSSION

A. Mootness

We first consider Debtor's argument that this appeal is moot. Debtor maintains that he has "quite possibly" spent the tax refunds and, therefore, ordering him to return the funds to the IRS may be impossible. He further argues that ordering him to return the money would derail the completion of his chapter 13 plan.

Debtor, as the party advocating mootness, bears the heavy burden of establishing that we cannot provide any effective relief to the IRS. *Suter v. Goedert,* 504 F.3d 982, 986 (9th Cir. 2007). Debtor has not met his burden here.

Constitutional mootness derives from Article III of the United States Constitution, which provides that the exercise of judicial power depends on the existence of a case or controversy. *DeFunis v. Odegaard,* 416 U.S. 312, 316 (1974); *PW, LLC,* 391 B.R. at 33. The doctrine of constitutional mootness is essentially a recognition of Article III's prohibition against federal courts' issuing advisory opinions. *North Carolina v. Rice,* 404 U.S. 244, 246 (1971). While the Article III mootness doctrine has a "flexible character," *U.S.*

Parole Comm'n v. Geraghty, 445 U.S. 388, 400 (1980), it applies when events occur during the pendency of the appeal that make it impossible for the appellate court to grant effective relief. *See PW, LLC,* 391 B.R. at 33, *citing Church of Scientology of Cal. v. United States,* 506 U.S. 9, 12 (1992). If no effective relief is possible, we must dismiss for lack of jurisdiction. *Church of Scientology,* 506 U.S. at 12.

A variation of the mootness rule, the equitable mootness doctrine, "applies when appellants 'have failed and neglected diligently to pursue their available remedies to obtain a stay' and circumstances have changed so as to 'render it inequitable to consider the merits of the appeal.'" *Darby v. Zimmerman (In re Popp),* 323 B.R. 260, 271 (9th Cir. BAP 2005) (citation omitted). We conclude that neither the constitutional nor equitable mootness doctrines apply to this appeal.

The rule in the Ninth Circuit is that where the order appealed involves the distribution of money and the party who received the funds is a party to the appeal, the appeal is not moot because the appellate court has the power to fashion effective relief by ordering the party to return the money. *See Spirtos v. Moreno (In re Spirtos),* 992 F.2d 1004, 1007 (9th Cir. 1993); *United States v. Arkison (In re Cascade Rds., Inc.),* 34 F.3d 756, 760 (9th Cir. 1994); *United States v. Valley Nat'l Bank (In re Decker),* 199 B.R. 684, 687 (9th Cir. BAP 1996). Under this rule, we can implement effective relief because Debtor is a party to the appeal, and we can order him to repay the money to

the IRS upon reversal of the bankruptcy court's rulings.

Debtor maintains that he has "quite possibly" spent the money, thereby making effective relief impossible. Simply because Debtor may have a present inability to repay the government does not mean effective relief is unavailable. *See United States v. Campbell,* 2003 WL 23241957 (W.D.N.Y. 2003) (finding that neither taxpayer's present inability to make restitution for an erroneously paid tax refund, nor mistake by the IRS in issuing an erroneous refund, excused taxpayer's legal obligation to repay amount of refund to the government). Therefore, the appeal is not constitutionally moot.

Further, although the IRS did not obtain a stay pending appeal, we perceive no reason to apply the equitable mootness doctrine and Debtor has not offered one. In response to our questions at oral argument in this appeal, we learned that the IRS had *mistakenly* refunded Debtor's tax overpayments to him while its Motion for Stay was pending. The IRS's mistaken payment explains why its Motion for Stay became moot and, therefore, the bankruptcy court never had an opportunity to rule on the IRS's request. We conclude that it is not inequitable to consider the merits of the appeal when the IRS's failure to obtain a stay was based on an administrative mistake.

We also cannot conceive how the money, which Debtor claims exempt, could derail the completion of his plan. Debtor committed excess income of $75 per

month to fund his plan, and the record contains no evidence that the tax refunds were used toward any of his plan payments.

Put simply, Debtor erroneously received the overpayments from the IRS. Debtor was aware that the IRS appealed the bankruptcy court's decision and would seek to recover the money from him if successful on appeal. Debtor "quite possibly" spent the money. We conclude that it would not be unjust to require him to repay it.

We recognize that the Eighth Circuit BAP has decided differently the mootness issue presented here. *Internal Revenue Serv. v. Ealy (In re Ealy),* 396 B.R. 20 (8th Cir. BAP 2008). In *Ealy,* the IRS moved for relief from the automatic stay to permit offset of the debtor's postpetition tax overpayment and economic stimulus payment under the Economic Stimulus Act of 2008 against his postpetition tax liability. The bankruptcy court denied the IRS's motion, concluding that the IRS was adequately protected by the debtor's confirmed plan, which provided for periodic payments in full of the postpetition tax liability.

The IRS appealed and sought a stay of the order pending appeal from the bankruptcy court. The bankruptcy court denied its request. The IRS paid the tax overpayment and the stimulus payment to the debtor. The IRS appealed the bankruptcy court's order denying it relief from stay.

The Eighth Circuit BAP concluded that the IRS no longer had a right of setoff because the mutuality

aspect of § 553 was lost because of the IRS's payment to the debtor. Therefore, the BAP held that even if it did reverse the bankruptcy court, it was impossible to grant the IRS effective relief since the IRS had sought relief from stay to effectuate its setoff rights.

We disagree with the Eighth Circuit BAP's decision in *Ealy* because it summarily ignores basic principles that underlie the doctrine of constitutional mootness. For example, there is no requirement that a court must return the parties "to the *status quo ante*." *Cascade Rds.*, 34 F.3d at 759. In the Ninth Circuit, the standard is that "'an appeal is not moot if the court can fashion *some* form of meaningful relief.'" *Id.* (emphasis in original). Here, reversal of the bankruptcy court's order simply will require Debtor to pay the IRS back.

Further, to follow *Ealy's* holding would

> 'have the unwelcome effect of encouraging disobedience to a court's order if a stay could not be obtained, thus presenting the [IRS] with a choice of losing its right to appeal or noncompliance.' [This] result would contravene the fundamental principle that 'a debtor against whom a judgment for money is recovered may pay that judgment and bring a writ of error to reverse it. . . . [In so doing], the defendant has merely submitted to perform the judgment of the court and has not thereby lost [its] right to seek a reversal of that judgment by writ of error or appeal.'

Cascade Rds., 34 F.3d at 760 (citations omitted). We conclude *Ealy* is unpersuasive and nonbinding.

Because the appeal is not moot, we consider the merits.

B. The IRS's Setoff Rights Were Preserved Under § 553

Setoff rights under the Bankruptcy Code are governed by § 553, which provides in relevant part that,

> Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case. . . .

As this panel, and the bankruptcy court, recognize, § 553 does not establish independent setoff rights in bankruptcy but rather preserves setoff rights existing under law independent of the Bankruptcy Code. *Cascade Rds.*, 34 F.3d at 763; *see also Wade Cook*, 375 B.R. at 591.

Setoff has venerable origins in Roman and common law, recognizing the principle that mutually offsetting debts between parties should be applied against each other to determine the balance owed. *See* Tigar, Michael E., *Automatic Extinction*

of Cross-Demands: Compensatio [sic] *from Rome to California,* 53 Cal. L. Rev. 224 (1965). "Since that time, setoffs in bankruptcy have been 'generally favored,' and a presumption in favor of their enforcement exists." *Carolco Television, Inc. v. Nat'l Broad. Co. (In re De Laurentiis Entm't Group Inc.),* 963 F.2d 1269, 1277 (9th Cir. 1992).

While setoff is by its nature equitable, setoff rights in many cases are governed by statute and are applied consistent with the governing statutory terms. *See, e.g.,* CCP § 431.70.[11]

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[11] CCP § 431.70 provides:

Where cross-demands for money have existed between persons at any point in time when neither demand was barred by the statute of limitations, and an action is thereafter commenced by one such person, the other person may assert in the answer the defense of payment in that the two demands are compensated so far as they equal each other, notwithstanding that an independent action asserting the person's claim would at the time of filing the answer be barred by the statute of limitations. If the cross-demand would otherwise be barred by the statute of limitations, the relief accorded under this section shall not exceed the value of the relief granted to the other party. The defense provided by this section is not available if the cross-demand is barred for failure to assert it in a prior action under Section 426.30. Neither person can be deprived of the benefits of this section by the assignment or death of the other. For the purposes of this section, a money judgment is a "demand for money" and, as applied to a money judgment, the demand is barred by the statute of limitations when enforcement of the judgment is barred under Chapter 3

(Continued on following page)

The IRS's setoff rights arise under IRC § 6402(a), which provides that,

> In the case of any *overpayment,* the Secretary, within the applicable period of limitations, may credit the amount of such *overpayment,* including any interest allowed thereon, against any *liability in respect of an internal revenue tax* on the part of the person who made the *overpayment* and shall . . . *refund any balance* to such person. (Emphasis added.)

The statute allows the IRS to credit "overpayments" against liabilities for taxes before determining whether a taxpayer is entitled to a "refund." The IRS contends that the bankruptcy court did not recognize the legal distinction between an overpayment and a refund, which the IRS maintains contributed to the error in the court's decision. We agree. When Congress uses different words in a statute, "'it usually means different things.'" *Shaw v. County of San Bernardino (In re Shaw),* 157 B.R. 151, 153 (9th Cir. BAP 1993) (citation omitted).[12]

(commencing with Section 683.010) of Division 1 of Title 9.

[12] It is an elementary precept of statutory construction that the definition of a term in the definitional section of a statute controls the construction of that term wherever it appears throughout the statute. *See* 1A Sutherland, Sutherland on Statutory Construction § 20.08 at 88 (6th ed. 2008). IRC § 6401(c) defines an "overpayment" negatively: "An amount paid as tax shall not be considered not to constitute an overpayment

(Continued on following page)

The Fifth Circuit specifically recognized that difference between an "overpayment" and a "refund" in *Internal Revenue Service v. Luongo (In re Luongo),* 259 F.3d 323, 335 (5th Cir. 2001), as follows:

> [U]nder 26 U.S.C. § 6402(a) the debtor is generally only entitled to a tax refund to the extent that her overpayment exceeds her unpaid tax liability. . . . In the present case, the estate had a tax liability totaling $3,800, while the 1997 overpayment totaled only $1,395.94. Section 6402(a) grants the IRS discretion whether to offset against a debtor's unpaid tax liability or to refund the overpayment to the taxpayer. The IRS elected to exercise that discretion to apply the overpayment to Appellant's past liability. Because the prior unpaid tax liability exceeded the amount of the overpayment, the debtor was not entitled to a refund and the tax refund did not become property of the estate. Absent an interest in the estate to the refund, it could not properly be exempted by the debtor under § 522.

Also, *see Pettibone Corp. v. United States,* 34 F.3d 536, 538 (7th Cir. 1994):

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solely by reason of the fact that there was no tax liability in respect of which such amount was paid." Although IRC § 6401(c) does not define what constitutes a refund, several statutes throughout the IRC use the terms overpayment and refund. *See* §§ 6402(a), (d) and (e), 6511 and 6512(b).

> The Internal Revenue Code leaves to the Commissioner's discretion whether to apply overpayments to delinquencies or to refund them to the taxpayer. 26 U.S.C. § 6402(a). Until the Commissioner exercises this discretion, the taxpayer has no right to payment.

In *Lyle v. Santa Clara County Dept. of Child Support Servs. (In re Lyle),* 324 B.R. 128, 131 (Bankr. N.D. Cal. 2005), the court observed:

> [T]he debtor's interest in a *refund* does not necessarily extend to the full value of any *overpayment* of taxes in a given tax year. *[Luongo,* 259 F.3d at 335.] Rather, the express provisions of the Internal Revenue Code make it clear that the debtor's interest in a refund is contingent on the subsequent statutory determination of what portion of the overpayment, if any, the debtor is entitled to receive as a refund. [*In re Martin,* 167 B.R. 609, 612-13 (Bankr. D. Or. 1994).] (Emphasis in original).

The bankruptcy court recognized from "relevant caselaw" that the terms "tax overpayment" and "tax refund" are not interchangeable, but based on certain unexplained analytical assumptions, treated them as essentially fungible despite that recognition. *See Gould,* 389 B.R. at 108 n.3. However, if the terms "overpayment" and "refund" in IRC § 6402(a) are treated as distinct, the record in this appeal appears in a very different light from the perception of the bankruptcy court.

Debtor had not filed his federal income tax returns for 1999 through 2004 when he filed his petition. His failure to file prompted the IRS to object to his plan on feasibility grounds. Debtor amended his Schedule C, claiming an exemption in "2002, 2003, 2004 Income Tax Refund[s]" even though Debtor had still not filed his federal income tax returns for 1999 to 2004. At that time, he had a contingent and unliquidated claim to a refund or refunds, and that claim was property of his bankruptcy estate, as recognized by the bankruptcy court. *See Gould,* 389 B.R. at 114; *Luongo,* 259 F.3d at 335; *Lyle,* 324 B.R. at 131.

The IRS did not object to Debtor's claimed exemption in the income tax refunds. Under IRC § 6402(a), if Debtor was entitled to a refund after his prepetition tax overpayments were applied against his unpaid prepetition income tax liabilities, the IRS arguably would have no basis to object to his exemption claim.

Debtor filed his federal income tax returns for 1999 to 2004 in June and July 2005. In his amended plan, Debtor committed excess disposable income of $75 a month for thirty-seven months to plan payments, but there was no provision for disposition of any tax refunds received by Debtor.

The IRS filed several amended proofs of claim. The IRS's Fourth Amended Claim included a secured setoff claim of $6,852, an unsecured priority claim of $307.51, and a general unsecured claim in the

amount of $2,812.93, for a total claim of $9,972.44. The automatic stay, however, prevented the IRS from exercising its setoff rights. *See* § 362(a)(7)[13]; *see also Pieri v. Lysenko (In re Pieri),* 86 B.R. 208, 210 (9th Cir. BAP 1988) (noting that the automatic stay does not defeat the right of setoff, but merely stays its enforcement pending an orderly examination of the debtor's and creditor's rights).

Accordingly, the IRS filed its Motion seeking relief from stay on October 25, 2005.[14]

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[13] We observe that if this case had been filed under BAPCPA, the IRS would not have to seek relief from stay to set off Debtor's tax overpayments. BAPCPA includes § 362(b)(26) which expressly excepts the setoff of prepetition tax refunds from the automatic stay. Section 362(b)(26) states in pertinent part: "The filing of a petition under section 301, 302, or 303 of this title, . . . does not operate as a stay – . . . under subsection (a), of the setoff under applicable nonbankruptcy law of an income tax refund, by a governmental unit, with respect to a taxable period that ended before the date of the order for relief against an income tax liability for a taxable period that also ended before the date of the order for relief. . . ."

[14] The IRS's Motion was not decided until the court issued its published decision on June 13, 2008. Generally, the hearing on a motion for relief from stay is a summary proceeding that requires the bankruptcy court's action to be quick and is limited to determining whether "the creditor has a colorable claim to the property of the estate." *Biggs v. Stovin (In re Luz Int'l, Ltd.),* 219 B.R. 837, 842 (9th Cir. BAP 1998). Here, the hearing was hardly accelerated, and both parties were able to fully brief and argue the substantive merits of the IRS's right to setoff under § 553. The IRS and Debtor have also extensively asserted their relative positions on the substantive setoff within the context of this appeal. We thus consider the merits of both rulings made by the

(Continued on following page)

C. The IRS's Motion for Relief from Stay

1. Section 362(d)(1): The IRS Established That Cause Existed for Granting Relief From Stay

The IRS, as the party seeking relief, must first establish a prima facie case that cause exists for relief under § 362(d)(1). *Duvar Apt., Inc. v. FDIC (In re Duvar Apt., Inc.),* 205 B.R. 196, 200 (9th Cir. BAP 1996). Once a prima facie case has been established, the burden shifts to Debtor to show that relief from the stay is not warranted. *See* § 362(g)(2)[15]; *Duvar Apt.,* 205 B.R. at 200.

The IRS argues that its right of setoff under IRC § 6402 and § 553 constitutes "cause" for relief from stay under § 362(d)(1). "Courts generally recognize that, by establishing a right of setoff, the creditor has established a prima facie showing of 'cause' for relief from the automatic stay under § 362(d)(1)." *In re Ealy,* 392 B.R. 408, 414 (Bankr. E.D. Ark. 2008) (citing cases).

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bankruptcy court-denial of the IRS's motion for stay relief under § 362(d)(1) and (2) and disallowance of its setoff rights under § 553 on equitable grounds. *See United States v. Offord Fin., Inc. (In re Medina),* 205 B.R. 216 (9th Cir. BAP 1996) (deciding setoff rights in the context of a motion to lift stay).

[15] Section 362(g) provides: "In any hearing under subsection (d) or (e) of this section concerning relief from the stay of any act under subsection (a) of this section – (1) the party requesting such relief has the burden of proof on the issue of the debtor's equity in property; and (2) the party opposing such relief has the burden of proof on all other issues."

Here, it is undisputed that the IRS possessed a valid right of setoff under § 553(a) and the bankruptcy court so found. Therefore, we conclude that the IRS made a prima facie showing that cause existed for relief from stay, thereby shifting to Debtor the burden of proving that relief was inappropriate in this case.

Debtor's only defense was that his exemption in the anticipated tax refunds was superior to the IRS's setoff rights. However, the amount of any claimed refund could not even be determined under IRC § 6402(a) until the IRS had applied Debtor's prepetition tax overpayments to his unpaid prepetition tax liabilities. That was the precise reason the IRS sought relief from stay, and the bankruptcy court erred as a matter of law in denying the IRS relief from stay under § 362(d)(1) to allow that process to proceed.

The bankruptcy court's *Taylor* analysis is not relevant because Debtor's contingent and unliquidated claim to tax refunds clearly was property of his estate, and the IRS had no basis to object to the claimed exemption. Ultimately, based on the factual record before the bankruptcy court and application of § 6402(a), Debtor's prepetition unpaid tax liabilities exceeded his prepetition tax overpayments, and there was no refund to which Debtor's claimed exemption could attach. *See Luongo*, 259 F.3d at 335; *Lyle*, 324 B.R. at 131-33.

Moreover, the Supreme Court in *Taylor* did not discuss, let alone offer any rationale, for the

bankruptcy court's conclusion that its holding operated to cut off a creditor's setoff rights, which are preserved in § 553. Notably, the Supreme Court was neither called upon to examine the plain language of § 553, nor did it discuss case law that analyzed the interplay between § 522(c)[16] and § 553.

While there was no conflict between § 553 and § 522(c) under this set of facts, if such a conflict did exist, our former decision in *Pieri,* 86 B.R. 208, would control.[17] *See California v. Rowley (In re Rowley),* 208 B.R. 942, 944 (9th Cir. BAP 1997) (noting that the panel is bound by its former decisions). In *Pieri,* the panel reconciled the conflict between § 553 and § 522(c) – which bars exempt property from being liable for any debt, with certain enumerated exceptions, that arose before the beginning of the case. In construing the two statutes, the panel noted that "[i]t is long settled that where there is an irreconcilable conflict between different parts of the same act, the last in order of arrangement will control." *Pieri,* 86

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[16] Section 522(c) provides: "Unless the case is dismissed, property exempted under this section is not liable during or after the case for any debt of the debtor that arose, or that is determined under section 502 of this title as if such debt had arisen, before the commencement of the case. . . ."

[17] In *Pieri,* the BAP affirmed the right of the landlord to set off her claims for damage to leased premises against the debtors' cause of action against the landlord arising out of the same circumstances, even though debtors claimed the cause of action as exempt property in their respective bankruptcy cases.

B.R. at 212-13. The BAP held that "[§] 553 would control over [§] 522(c) on any point of conflict." *Id.*

The Ninth Circuit's reasoning in *De Laurentiis*, 963 F.2d 1269, also provides support for deciding that § 553 trumps § 522(c). In *De Laurentiis*, the Ninth Circuit considered the conflict between § 553 and § 1141[18] and found that § 553 controlled. In reaching its conclusion, the court relied on the language and structure of § 553 and the policies that underlie it. *Id.* at 1276.

Section 553 provides that, with listed exceptions not relevant here, "this title does not affect the right of any creditor to offset a mutual debt. . . ." The Ninth Circuit found that this language established a right to setoffs in bankruptcy and manifested a Congressional intent that it control "*notwithstanding any other provision of the Bankruptcy Code.*" (Emphasis added.) *Id.* at 1276-77.

The Ninth Circuit also found that a contrary conclusion would essentially nullify § 553, because

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[18] Section 1141, titled "Effect of confirmation", provides in subsection (a): "Except as provided in subsections (d)(2) and (d)(3) of this section, the provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan."

§ 553 does not create the right of setoff, but merely preserves it. The court opined that if § 1141 were given precedence over § 553, then setoffs would be allowed under Chapter 11 only where they were written into a plan of reorganization. *Id.* at 1277.

Finally, the Ninth Circuit acknowledged the long history of setoffs in both the nonbankruptcy and bankruptcy contexts. The court found no indication, from § 553 or elsewhere, of an intent to deviate from this historical precedent of recognizing setoff rights. *Id.*

Following the analysis in *De Laurentiis*, we reach the same conclusion that our former panel did in *Pieri,* albeit using a different vein of statutory construction. We conclude that the plain language of § 553 provides the answer to what the bankruptcy court viewed as the primary question before it: whether the IRS's setoff should be allowed against property that Debtor had already fully exempted without challenge by the IRS or any other party. *Gould,* 389 B.R. at 111. Section 553(a), applied by its terms, dictates that the IRS's right to offset a mutual debt is not affected by any other section of the Code (with certain exceptions not relevant here). *United States v. Ron Pair Enters. Inc.,* 489 U.S. 235, 241-42 (1989) (as with all issues of statutory interpretation, we begin with the words of the statute; if it is clear, we must apply it by its terms unless to do so would lead to absurd results). We conclude that to give Debtor's exemption in his claim to the tax refunds

precedence over § 553 would be to ignore the plain language of § 553.

Moreover, under these circumstances the rule adopted by the bankruptcy court recognizing allowed exemptions as being superior to a creditor's setoff rights under nonbankruptcy law puts creditors in a position of having to object to a debtor's exemptions to preserve their setoff rights already provided for in § 553. This approach would result in needless objections to exemptions and would render § 553 largely meaningless.

Finally, we discern no policy arguments that would induce us to deviate from the presumption in favor of setoffs under this set of facts.

Therefore, we reinforce our previous holding in *Pieri* that § 553 controls over § 522(c). We conclude that the bankruptcy court abused its discretion in denying the IRS relief from stay under § 362(d)(1) by basing its ruling on the holding in *Taylor,* 503 U.S. 638.

2. Section 362(d)(2)

Under § 362(d)(2), the court must grant relief from stay against property if Debtor does not have equity in the property and it is not necessary to an effective reorganization. The IRS has the burden of proof on the issue of Debtor's equity in the property. *See* § 362(g).

The bankruptcy court did not directly address whether the IRS had established that Debtor had no equity in his claimed tax refunds. If such a showing were made, the burden would shift to Debtor to establish that the claimed tax refunds were necessary for an effective reorganization of his affairs in chapter 13. Consistent with the Fourth Amended Claim and the parties' agreement in arguing the Motion, the amount of Debtor's prepetition overpayments totaled $6,852.00. In the Fourth Amended Claim, the IRS claimed unpaid prepetition tax liabilities totaling $9,972.44. Applying Debtor's prepetition tax overpayments to his prepetition unpaid tax liabilities leaves a balance of unpaid tax liabilities of $3,120.44. Accordingly, if the IRS in its discretion under IRC § 6402(a) applied Debtor's tax overpayments to his unpaid liabilities, there is no equity for Debtor, and further, there is no refund to which Debtor's claimed exemption could attach. *See Luongo,* 259 F.3d at 335; *Lyle,* 324 B.R. at 131-33.

Debtor presented no evidence that the tax refunds in which he claimed an exemption were necessary to an effective reorganization in chapter 13. In fact, his confirmed plan provided for payments only from excess disposable income and did not specify how any tax refunds recovered for prepetition periods were to be spent. On this record, the bankruptcy court erred as a matter of law in denying the IRS relief from stay under § 362(d)(2).

D. The Bankruptcy Court's Alternative Holding: Disallowance of the IRS's Setoff Rights on Equitable Grounds

Allowance of setoff rights under § 553 is permissive, not mandatory. *Cascade Rds.*, 34 F.3d at 763 (noting that the allowance of setoff rights is discretionary)[19]; *FDIC v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 701 F.2d 831, 836-37 (9th Cir. 1983) (denying the bank's claim of setoff against the debtors' bank deposits on public policy grounds). However, we have previously observed that "the setoff right is an established part of our bankruptcy laws [and] should be enforced 'unless compelling circumstances' require otherwise." *Camelback Hosp., Inc. v. Buckenmaier (In re Buckenmaier)*, 127 B.R. 233, 237 (9th Cir. BAP 1991) (citation omitted).

Against this background, we consider whether the bankruptcy court's decision to disallow the IRS's setoff right on equitable grounds was an abuse of its discretion. We cannot reverse on this ground unless we have a definite and firm conviction that the bankruptcy court committed a clear error of judgment in the conclusion it reached after weighing the relevant factors. *Cashco Fin. Servs., Inc. v. McGee (In re McGee)*, 359 B.R. 764, 769-70 (9th Cir. BAP 2006). However, a bankruptcy court necessarily abuses its

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[19] In *Cascade Rds.*, the bankruptcy court's decision denying setoff was affirmed based on the fact that the case was replete with inequitable conduct on the part of the party seeking setoff. *Id.* at 762.

discretion if it bases its decision on an erroneous view of the law or clearly erroneous factual findings. *Id.*

In finding that the equities weighed in Debtor's favor, the court considered the following factors: (1) the IRS did not object to Debtor's exemption in the tax refunds; (2) the IRS did not ask for an extension of time to object, under Rule 4003(b); (3) the IRS's rights under IRC § 6402(a) "were just the same as any other creditor's setoff rights. . . ."; (4) the IRS's discretionary right of setoff was not timely exercised because it did not move for relief from stay until several months after Debtor claimed his exemption;[20] and (5) Debtor's financial position weighed heavily in favor of denying the IRS's claim of setoff.

With respect to the last factor, the court observed that Debtor had absolutely nothing else but the tax refunds in question to provide him with the "basic necessities of life." The court concluded that allowing the IRS to set off the tax refunds would take from Debtor his wildcard exemption, which was the most "important exemption available to him as a non-homeowner" and contrary to "bankruptcy policy and

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[20] We observe that § 553 does not contain a time limitation by which the IRS must move for relief from stay to accomplish its setoff rights. According to the record, Debtor claimed his exemption in the tax refunds before he had filed the returns for the years he sought the refunds. *Gould,* 389 B.R. at 109. Thus, it was not surprising that the IRS waited to file its motion for stay relief.

California state exemption policy." *Gould,* 389 B.R. at 129.

The bankruptcy court relied heavily for its equitable determination on the fact that the IRS did not object to Debtor's claimed exemption in the tax refunds and waited several months before filing the Motion. As explained above, the IRS had no basis to object to Debtor's exemption because his contingent and unliquidated claim to the tax refund clearly was property of his estate. Moreover, applying IRC § 6402(a) shows that there was no refund to which Debtor's claimed exemption could attach because his prepetition unpaid tax liabilities exceeded his prepetition tax overpayments. Accordingly, there are no tax refunds in which the bankruptcy estate had a property interest. *Luongo,* 259 F.3d at 335; *Lyle,* 324 B.R. at 131-33.

The bankruptcy court also treated the IRS's setoff rights as analogous to setoff rights available to other creditors. However, the IRS's setoff rights are specified by IRC § 6402(a) and must be applied according to its terms. Being based on statute, the IRS's setoff rights are not "just the same as any other creditor's setoff rights." The bankruptcy court's decision disregarded the distinct terms under which the IRS can exercise a setoff, and that lapse alone constitutes an abuse of discretion.

The bankruptcy court also based its equitable determination on Debtor's having absolutely nothing else but the tax refunds in question to provide him

with the "basic necessities of life."[21] *Gould,* 389 B.R. at 129. The bankruptcy court concluded that allowing the IRS to set off the tax refunds would take from Debtor his wildcard exemption, which was the most "important exemption available to him as a non-homeowner" and contrary to "bankruptcy policy and California state exemption policy." *Gould,* 389 B.R. at 129.

The last equitable factor weighed by the bankruptcy court implicates important public policies behind bankruptcy and California exemption laws. In *Pieri,* the panel recognized that exemption statutes are to be given a liberal construction and that "[t]his liberal view will be maintained in state policy governing the use of setoff against exempt property." 86 B.R. at 213. Thus, while the *Pieri* panel held that § 553 would control over § 522(c), we acknowledge that it did not foreclose a bankruptcy court from considering whether any state policy of protecting the rights of a debtor is present in the case.

Nevertheless, we question whether California exemption policy holds any weight under these circumstances when a federal statute such as IRC § 6402 controls the IRS's setoff rights. In *Pieri,* the

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[21] There was no evidence in the record that Debtor needed the tax refunds to provide him with the basic necessities of life. The only offer of proof was that Debtor was a single father with teenage children and, therefore, needed the money. Moreover, Debtor was funding his plan with excess income of $75 a month, which directly conflicts with the bankruptcy court's finding.

right of setoff was authorized under California law based on equitable principles. Here, the IRS's right of setoff is not based on equitable principles but on IRC § 6402, which is a federal statute that does not recognize state exemptions. *See In re Bourne,* 262 B.R. 745, 749-50 (Bankr. E.D. Tenn. 2001). Arguably, the Supremacy Clause of the United States Constitution prevents state exemption laws from defeating federal setoff rights provided under IRC § 6402. *Id.*

However, even if a consideration of state exemption policy could override the IRS's setoff rights preserved in § 553, the circumstances in *Pieri* are distinguishable from those in this case. California courts have disallowed a setoff against exempt property that provides income necessary to pay daily living expenses. *Kruger v. Wells Fargo Bank,* 11 Cal. 3d 352 (1974) (disallowing setoff against the debtor's bank account, which contained unemployment compensation and disability benefits); *Barnhill v. Robert Saunders & Co.,* 125 Cal. App. 3d 1 (Cal. Ct. App. 1981) (preventing an employer from setting off debts owed to it by an employee's exempt wages owed to him). In each case, state policies protecting the debtor's interest apparently outweighed the creditor's right to setoff. The record in this appeal does not support Debtor's claim of exemption to provide a source of income to pay his daily living expenses. Debtor's confirmed chapter 13 plan provides for payments of $75 disposable income in excess of expenses during each month of the term of the plan.

Finally, the Ninth Circuit in *De Laurentiis* discussed the equities in favor of setoff. The court noted that the defense of setoff allows the creditor to claim an amount large enough to set off its debt. *De Laurentiis,* 963 F.2d at 1277. Absent such a right, it would have to pay its debt in full, yet receive pennies on the dollar. The court observed that this result was unfair, which was why setoffs "were allowed in bankruptcy in the first place." *Id.*

We recognize the unfairness that would result from barring a setoff in the case before us. The IRS initially objected to Debtor's plan on the ground that he had unpaid tax liabilities for the very years he claimed refunds. The IRS asserted its setoff rights during the pendency of the bankruptcy proceeding by filing a motion for relief from stay and a proof of claim, a portion of which was based on its setoff rights. Therefore, Debtor was on notice that the IRS would seek to set off his overpayments against his liabilities.

The record reflects that as a matter of procedure, the IRS played by the rules. It did not attempt to offset Debtor's tax overpayments against his tax liabilities in the absence of relief from stay. After Debtor filed his tax returns for 1999 to 2004, the IRS filed the Motion to obtain that relief. The bankruptcy court denied the Motion, and the IRS turned over the $6,852.00 in tax overpayments to Debtor pursuant to the bankruptcy court's order before there was a formal application of the overpayments to determine if Debtor even was entitled to a refund. Under these

circumstances, as a matter of equity, we do not see any factors weighing in Debtor's favor based on the IRS's conduct in this matter.

Accordingly, we conclude that the court abused its discretion in disallowing the IRS's setoff rights under § 553 on equitable grounds.

VI. CONCLUSION

We REVERSE the bankruptcy court's denial of the IRS's motion for relief from stay for the reasons set forth above and REMAND for entry of an order consistent with this opinion.

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re	]	Case No. 05-50292-ASW
Anthony S. Gould,	]	Chapter 13
Debtor.	]	R.S. No. JWS-28

AMENDED MEMORANDUM DECISION ON MOTION FOR RELIEF FROM STAY BY IRS[1]

Before the Court is the Motion by United States for Relief from Stay to Set Off Tax Refund (the "Motion") brought by the United States of America, for itself and on behalf of the Internal Revenue Service (collectively, the "IRS"). The IRS requests that the automatic stay of Bankruptcy Code § 362[2] be modified to permit it to offset pre-petition income tax liabilities owed by debtor Anthony S. Gould ("Debtor") against pre-petition income tax refunds[3] claimed by Debtor.

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[1] This Amended Memorandum Decision does not substantively change the Court's decision – it adds some cases not previously cited, clarifies certain points and makes some minor corrections.

[2] Unless otherwise provided, all references to code sections shall mean the Bankruptcy Code, codified in Title 11 of the United States Code, 11 U.S.C. § 101, *et seq.*, including all amendments thereto.

[3] While the Motion primarily refers to "tax refunds," it also uses the term "tax overpayment." The Court notes that these terms, at least as used in some of the relevant caselaw, are not interchangeable. The use of the term "tax overpayment" has

(Continued on following page)

Debtor is represented by David A. Boone, Esq. and Leela V. Menon, Esq. of the Law Offices of David A. Boone. Special Assistant United States Attorneys John W. Strate and Rex K. Lee represent the IRS.

This Memorandum Decision constitutes the Court's findings of fact and conclusions of law, pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure.

I.

FACTS

Debtor is a divorced father with two teenage dependent children.[4] He earns $3,100 per month working as a mechanic,[5] and his monthly expenses are $3,025.[6] He has very few assets and very few liabilities, other than tax liabilities and refunds. Debtor's only significant assets are a 1987 Jeep Cherokee, a state income tax refund in the amount of $3,217.00, and the federal income tax refund in the amount of $6,852.00 currently at issue.[7]

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certain built-in analytical assumptions. For this reason, the Court shall use the more neutral term "tax refund."

[4] *See* Schedule I.

[5] Schedule I shows Debtor earns $3,100.00 per month working as a mechanic for Railway Distributing. This is his only source of income.

[6] *See* Schedule J.

[7] *See* Amended Schedule A and Amended Schedule B. Debtor's Amended Schedule B lists personal property with a

(Continued on following page)

Debtor's only significant debts are for income taxes.[8] Prior to the filing of his bankruptcy case, Debtor failed to file federal tax returns for 1999 through 2004. Pre-petition, Debtor owed roughly $28,000 to the Franchise Tax Board (the "FTB") and roughly $10,000 to the IRS for unpaid income taxes stretching back to 1991.

On January 20, 2005 (the "Petition Date"), Debtor filed his Voluntary Petition under Chapter 13 of the Bankruptcy Code, his Chapter 13 Plan (the "Original Plan") and his Schedules.

The IRS filed its initial proof of claim against Debtor on February 24, 2005, which included estimated income taxes due for 1999-2004.[9] On March 2, 2005, the IRS filed an objection to confirmation of the Original Plan on the basis of Debtor's failure to file

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current market value of only $15,964.00 – of which, $11,047.00 is attributable to federal tax refunds and $3,217.00 is attributable to state tax refunds.

[8] The only secured claim noted on Amended Schedule D is a tax lien by the FTB securing a claim of $28,122.57. Amended Schedule E only lists priority claims by the FTB in the amount of $4.00 and by the IRS in the amount of $255.00 – both for 2001 income taxes. Schedule F shows six general unsecured claims totaling $32,822.62 -- the largest being a $27,078.55 debt to the FTB for 1993-1998 income taxes. The Claims Register shows seven proofs of claim have been filed in this case – five by the IRS, one by the FTB asserting a secured claim of $28,122.57, and one by Wells Fargo Bank asserting a general unsecured claim of $447.38.

[9] United States' (IRS's) Supplemental Brief in Support of Motion for Relief from Stay, filed May 15, 2006, 3:15-18.

tax returns and the Original Plan's failure to provide full payment for the IRS's priority claim as required by Bankruptcy Code § 1322(a)(2).[10]

On May 26, 2005, Debtor filed Amended Schedules B, C, D and E (the "Amended Schedules"). On his Amended Schedule B, Debtor lists claims for federal income tax refunds for tax years 2002, 2003 and 2004 totaling $11,047.00.[11] On his Amended Schedule C, Debtor claimed the following exemptions:

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[10] On March 15, 2005, the Chapter 13 Trustee also filed an objection to the Original Plan on the basis of Debtor's failure to file his federal income tax returns for 2001-2004. This objection was withdrawn on September 13, 2005, after Debtor filed said tax returns.

[11] Debtor has subsequently acknowledged that this amount is incorrect. The tax refunds claimed as exempt by Debtor actually total $6,852. *See* Declaration of Debtor as to Facts Re Opposition to Internal Revenue Service's Motion for Relief from the Automatic Stay, filed January 18 [sic], 2006, at 2:14-17 ("I have exempted a total of $11,047.00 in tax refunds in the Amended Schedule C filed with the Court based upon an expected refund of $4,1950.00 [sic] for 2003. However, the Amended return filed for that year, 2003, indicates a liability due in the amount of $2,314.00.")

Property	Basis in Cal. Civ. Proc. Code ("CCP")	Value
Household furniture, appliances, etc.	703.140(b)(3)	$ 500.00
Clothes, shoes and accessories	703.140(b)(3)	$ 300.00
Checking account	703.140(b)(5)	$ 400.00
1987 Jeep Cherokee	703.140(b)(2)	$ 500.00
2002, 2003, 2004 Fed Income Tax Refunds	703.140(b)(5)	$6,852.00[12]
2002, 2003, 2004 FTB Refunds	703.140(b)(5)	$3,217.00

No party, including the IRS, filed a timely objection to the exemptions claimed by Debtor in his Amended Schedule C.

At the time Debtor filed the Amended Schedules, Debtor had not yet filed his tax returns for the years 1999 through 2004.[13] In June and July of 2005, Debtor filed these tax returns. The balances indicated on these tax returns by Debtor are as follows:

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[12] Amended Schedule C incorrectly states the amount of this claimed exemption to be $11,047.00. *See* footnote 11 *supra*.

[13] The IRS could have objected to the exemptions on the basis that Debtor had not filed these tax returns, but the IRS did not do so.

Year	Refund Claimed	Deficiency Owed
1999	$2,226.00	
2000	$2,291.00	
2001		$255.00
2002	$2,414.00	
2003		$2,314.00
2004	$4,438.00	
	$11,369.00[14]	$2,569.00

Declaration of Debtor as to Facts Re Opposition to Internal Revenue Service's Motion for Relief from the Automatic Stay ("Debtor's Decl."), filed January 18, 2006, 2:7-17.

After Debtor filed his Amended Schedules and his tax returns for 1999 through 2004, the IRS filed several subsequent amended Proofs of Claim.[15]

Debtor filed his First Amended Chapter 13 Plan on May 26, 2005 (the "Amended Plan"). No objections were filed to the Amended Plan. The Amended Plan

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[14] The 1999 and 2000 claims for refund are presumably barred by the statute of limitations to seek such refunds. 26 U.S.C. § 6511(a). This issue was not addressed by the parties. However, the Court notes this potential bar, as those amounts might otherwise impact the IRS's claim of setoff.

[15] The IRS filed its first amended Proof of Claim on July 8, 2005, which was objected to by Debtor on August 19, 2005. On August 26, 2005, the IRS filed its second amended Proof of Claim, asserting a priority claim of $307.51 and an unsecured claim of $9,664.93, for a total of $9,972.44 – including penalties and interest.

was confirmed on October 5, 2005. The Amended Plan provides that Debtor will pay the sum of $75 per month to the Chapter 13 Trustee for a term of 37 months. This results in a distribution to general unsecured claims of approximately 2 cents on the dollar.[16]

The IRS filed this Motion on October 25, 2005 seeking to exercise certain alleged setoff rights under Bankruptcy Code § 553. Specifically, the Motion asked that the automatic stay be modified to allow the IRS to "offset the tax refunds totaling $8,733 owed by the IRS to the debtor against the IRS' claim of $9,972.44 against the debtor." Motion, 4:2-4.

While this Motion was pending before the Court, the IRS filed two subsequent amended proofs of claim. On May 22, 2006, the IRS filed its third amended Proof of Claim, asserting a priority claim of $2,709.93 and an unsecured claim of $9,780.63, for a total of $12,490.56. On July 10, 2006, the IRS filed a fourth and final amended proof of claim, in the total amount of $9,972.44 (the "IRS's Final Proof of Claim"), divided as follows:

Secured Claim pursuant to "Right to setoff"
$2,702.17 Deficiency owed for 1991 tax period
$2,488.72 Penalty on 1991 deficiency to Petition Date
$1,661.11 Interest on 1991 deficiency to Petition Date
$6,852.00

[16] Under the Amended Plan, there are no secured claims.

Unsecured Priority Claim under 507(a)(8)[17]

$255.00	Deficiency owed for 2001 tax period
$52.51	Interest on 2001 deficiency to Petition Date
$307.51	

General Unsecured Claim

$2,679.78	Balance of Pre-petition interest for 1991 deficiency
$133.15	Interest to Petition Date Priority Claim for 2001 deficiency
$2,812.93	

The balances owing between the parties are unclear. The amounts of the income taxes or refunds owing, as asserted by both parties, have repeatedly changed in the course of the case and the pendency of this Motion. In addition, the amount of the "wild card" exemption asserted by Debtor has – at least in the body of the pleadings relating to this Motion, although not in the Amended Schedule C itself – been reduced from $11,047.00 to $6,852.00.[18] Correspondingly, the IRS reduced its request for setoff from $8,733 to $6,852 – the total of the 2002 and 2004

[17] Even though Debtor has stated that he owes a deficiency in the amount of $2,314.00 for tax year 2003, the IRS has not included such an amount in the amounts the IRS asserts as owing. *See* Debtor's Decl. at 2:7-17. Indeed, the IRS's Final Proof of Claim indicates "$0.00" tax due for 2003.

[18] Debtor's Decl. at 2:14-17.

refunds Debtor alleges is owed to him.[19] The IRS's alleged right of setoff is the sole basis for the $6,852.00 secured portion of the IRS' Final Proof of Claim. Debtor disputes the secured status of the $6,852.00 portion of the IRS's Final Proof of Claim, and has reserved his right to object thereto pending this decision by the Court.[20] For the purposes of this Motion, the parties agree that the amount the IRS now seeks to set off is $6,852.00.[21]

II.

ANALYSIS

The issue before the Court is whether the IRS should be granted relief from stay, pursuant to Bankruptcy Code § 362, to allow the IRS to offset, pursuant to § 553, Debtor's pre-petition income tax liabilities against Debtor's pre-petition income tax refunds.[22] The total amount of the IRS's Final Proof of

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[19] United States' (IRS's) Supplemental Brief In Support of Its Motion for Relief from Stay ("IRS's Supp. Brief"), filed May 15, 2006, at 4:20.

[20] Debtor's Statement Regarding Claim Amount in Set-off Request by Motion for Relief from Stay ("Debtor's Statement"), filed February 28, 2007, at 2:20-25.

[21] *See* Debtor's Statement at 2:26-27; IRS's Final Proof of Claim; and IRS's Supp. Brief at 4:17-20.

[22] The Court notes that, for cases filed after October 17, 2005, the newly added Bankruptcy Code § 362(b)(26) provides that the setoff by the IRS of a pre-petition tax refund is not stayed. This new section was added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. No.

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Claim is $9,972.44, for taxes owing for tax years 1991 and 2001 and pre-petition interest and penalties thereon. Debtor has asserted a claim for an income tax refund for tax years 2002 and 2004 totaling $6,852. By the Motion, the IRS seeks to apply the entire $6,852 owing by the IRS to Debtor against the $9,972.44 tax liability owed by Debtor. If the Motion is granted, the IRS will receive roughly $7,159.51 or slightly over 71% of the $9,972.44 total of the IRS's Final Proof of Claim plus a pro rata distribution on the $2,812.93 balance under the Amended Plan.[23] If the Motion is denied, the IRS will receive $307.51 as a priority claim and a pro rata distribution on the balance of $9,664.93.

While this difference in the potential recovery on the IRS's Final Proof of Claim is significant, this case presents a much more significant issue than whether, on the facts here presented, the IRS can establish a right of setoff under § 553, thereby establishing cause for relief from the automatic stay under § 362. This larger issue arises from Debtor's opposition to the Motion. Debtor has opposed the Motion on the basis that the IRS is not entitled to set off against the 2002

109-8, 199 Stat. 23 § 418 (Apr. 20, 2005). While this provision eliminates the need for the IRS to bring a motion for relief from stay, it does not resolve the issue of whether the IRS may set off against tax refunds after the debtor has exempted such funds under § 522, without objection.

[23] The $7,159.51 payment is comprised of the $6,852 setoff amount plus $307.51 owed as a priority claim under § 507(a)(8).

and 2004 refunds because Debtor has already fully exempted the refunds pursuant to Bankruptcy Code § 522 and CCP § 703.140(b)(5). Debtor argues that such exemption gives him a superior right to the $6,852. The primary issue presented by the Motion, therefore, is whether the setoff should be allowed against property the debtor has already fully exempted – without challenge by the IRS or any other party.

A. The Applicable Statutory Provisions

1. The Automatic Stay of Bankruptcy Code § 362

Bankruptcy Code § 362 imposes an automatic stay against certain acts by creditors against the debtor or property of the estate. Included among the acts prohibited by the automatic stay is "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor[.]" 11 U.S.C. § 362(a)(7). No exception is made under § 362 – at least as written prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "BAPCPA") – for setoffs by the IRS.[24] Therefore, the unambiguous

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[24] The Petition Date was January 20, 2005. The BAPCPA was enacted on April 20, 2005. A few of its provisions became immediately effective, but the majority of the BAPCPA's amendments became effective on October 17, 2005 – 180 days after its enactment. Because Debtor's bankruptcy case was commenced prior to the effective date of the BAPCPA, the provisions added

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language of § 362(b)(7) stays any right the IRS might otherwise have to set off tax refunds against tax liabilities owing by Debtor.

Even though the IRS's right to set off is stayed by the automatic stay, the IRS, like any other creditor, may ask the court to lift the stay to allow it to exercise a right of setoff. As explained by the Ninth Circuit BAP in *In re Pieri,* 86 B.R. 208, 210 (9th Cir. BAP 1988):

> Under the Code, the allowance of setoff is not automatic but is instead permissible at the discretion of the bankruptcy court, applying general principles of equity. [citations omitted] . . . In order to insure that questions concerning setoff are presented to the court for determination, Section 362(a)(7) specifically stays setoff. The automatic stay does not defeat the right of setoff. Rather, it merely stays its enforcement pending an orderly examination of the debtor's and creditor's rights. [citations omitted]

2. Setoff Under Bankruptcy Code § 553 and Internal Revenue Code § 6402(a)

Bankruptcy Code § 553 addresses a creditor's right of setoff in the bankruptcy context. It provides, in pertinent part, as follows:

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by the BAPCPA are inapplicable to Debtor's case. See footnote 22 *supra* and section II(C)(4) *infra*.

> Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case[.]

11 U.S.C. § 553(a). Section 553 does not create a federal right of setoff, but preserves existing rights under applicable non-bankruptcy law. *Citizens Bank of Maryland v. Strumpf,* 516 U.S. 16, 18, 116 S.Ct. 286, 289, 133 L.Ed.2d 258 (1995); *In re De Laurentiis Ent. Group, Inc.,* 963 F.2d 1269, 1277 (9th Cir. 1992).

The IRS's ability to offset tax liabilities against tax refunds is found at Internal Revenue Code ("IRC") § 6402(a), which provides:

> In the case of any overpayment, the Secretary, within the applicable period of limitations, ***may*** credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall, subject to subsections (c), (d) and (e), refund any balance to such person.

26 U.S.C. § 6402(a) (emphasis added).

In addition to the requirements for setoff under the applicable non-bankruptcy law – in this case, the elements of IRC § 6402(a) set forth above – § 553

imposes certain additional requirements in the bankruptcy context. To establish a valid setoff right under § 553, the IRS must prove: (1) a debt owed by the creditor to the debtor arising pre-petition; (2) a claim of the creditor against the debtor arising pre-petition; and (3) the debt and claim are mutual obligations. *In re Verco Industries,* 704 F.2d 1134, 1139 (9th Cir. 1983).

There is no dispute that the tax debts and requests for refund in question are mutual pre-petition obligations between Debtor and the IRS. It is undisputed that, but for Debtor's bankruptcy filing, the IRS would be able to exercise its right under IRC § 6402(a) to apply the refunds in this case to Debtor's unpaid tax liabilities.[25] The IRS argues that, pursuant to § 553, it retains the same rights in bankruptcy, and, therefore, should be permitted to set off Debtor's unpaid tax liabilities against his tax refunds, as provided for by IRC § 6402(a).[26] Absent the exemption

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[25] *See De Laurentiis,* 963 F.2d at 1276 (Chapter 11 discharge did not bar a creditor from raising a pre-petition claim as a setoff against an action brought by the debtor); *In re Buckenmaier,* 127 B.R. 233, 239 (9th Cir. BAP 1991) (creditor's setoff of its contingent claim for contribution was not enjoined by Chapter 7 discharge).

[26] While it is true that, even within the Bankruptcy Code, there is a strong policy of encouraging the payment of taxes by individuals, the Bankruptcy Code does, nonetheless, provide rights to individuals, vis-a-vis their taxes, that they would not have outside of bankruptcy. For example, non-priority tax debts can be discharged under §§ 727, 1141 and 1328. In addition, in a Chapter 13 case, a debtor has the ability to discharge even

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by Debtor of the refunds in dispute, there would be no question that the IRS should be allowed to exercise its right of setoff under Bankruptcy Code § 553 and Internal Revenue Code § 6402(a).

Setoff rights in bankruptcy are "'generally favored,' and a presumption in favor of their enforcement exists." *De Laurentiis*, 963 F.2d at 1277 (quoting *In re Buckenmaier*, 127 B.R. 233, 237 (9th Cir. BAP 1991)). Setoff is, however, permissive, rather than mandatory, and the decision ultimately rests within the discretion of the court. *In re Cascade Roads, Inc.*, 34 F.3d 756, 763 (9th Cir. 1994). In exercising its discretion, the Bankruptcy Court is to apply the general principles of equity. Setoff, even where otherwise authorized, should not be allowed when it would be inequitable or against public policy to do so. *FDIC v. Bank of America Nat'l Trust and Savings*, 701 F.2d 831, 836-37 (9th Cir. 1983), *cert. denied*, 464 U.S. 935 (1983).

3. Debtor's Exemptions under § 522 and CCP § 730.140(b)

To help provide a bankruptcy debtor with a "fresh start" after bankruptcy, the Bankruptcy Code allows the debtor to exempt certain property. *United States*

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priority tax debts upon the completion of plan payments under § 1328(a). Further, plans in bankruptcy cases allow debtors to pay tax debts over time, without the risks of garnishment or attachment.

v. Security Industrial Bank, 459 U.S. 70, 72 n.1, 103 S.Ct. 407, 409 n.1, 74 L.Ed.2d 235 (1982). In enacting § 522, Congress noted "[t]he historical purpose of these exemption laws has been to protect a debtor from his creditors, to provide him with the basic necessities of life so that even if his creditors levy on all of his nonexempt property, the debtor will not be left destitute and a public charge." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. at 126 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6087. Section 522(c) bars exempt property from being liable for any debt that arose before the commencement of the case, with certain enumerated exceptions not present here. A debtor has the ability to remove property from, or acquire property of, the estate by claiming exemptions. *Owen v. Owen*, 500 U.S. 305, 308, 111 S.Ct. 1833, 1835, 114 L.Ed.2d 350 (1991).

Property cannot be exempted unless it first falls within the bankruptcy estate. *Owen*, 500 U.S. at 308; *In re Heintz*, 198 B.R. 581, 586 (9th Cir. BAP 1996). The bankruptcy estate is comprised of all legal and equitable interests owned by the debtor as of the commencement of the case. 11 U.S.C. § 541(a)(1). Even if claims held by the debtor are contingent and/or unliquidated, they still become property of the estate as of the commencement of the bankruptcy case.[27] It is well established that unliquidated claims

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[27] *Sierra Switchboard Co. v. Westinghouse Electric Corp.*, 789 F.2d 705, 708 (9th Cir. 1986) (unliquidated emotional distress claim); *In re Ryerson*, 739 F.2d 1423, 1425 (9th Cir.

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for tax refunds for pre-petition taxable years are included within the property of the estate.[28]

Section 522(b) permits a debtor to "exempt (1) property under the federal exemptions contained in Section 522(d), unless State law does not so authorize, or (2) property exempt under State or local law, or other federal law." *In re Higgins,* 201 B.R. 965, 966 (9th Cir. BAP 1996). Because California has opted out of the federal exemption scheme, State law governs the right to an exemption in this case. 11 U.S.C. § 522(d); CCP § 703.130. Under California law, a bankruptcy debtor may choose between two sets of exemptions: (1) the exemptions available under CCP § 703.140(b) or (2) regular state law exemptions. CCP § 703.140(a). The exemptions afforded by CCP § 703.140(b), which were elected by Debtor in this case, are substantially similar to those under Bankruptcy Code § 522(d).

Debtor scheduled his claims for income tax refunds as exempt under CCP § 703.140(b)(5), which closely mirrors Bankruptcy Code § 522(d)(5). These sections are commonly referred to as the "wild card"

1984) (contingent contractual provisions); *In re Bronner,* 135 B.R. 645, 647 (9th Cir. BAP 1992) (unliquidated bad faith lawsuit); *In re Wischan,* 77 F.3d 875, 877 (5th Cir. 1996) (unliquidated personal injury causes of action).

[28] *Kokoszka v. Belford,* 417 U.S. 642, 648, 94 S.Ct. 2431, 2435, 41 L.Ed.2d 374 (1974); *Mueller v. Commissioner,* 496 F.2d 899, 903 (5th Cir. 1974); *In re Barowsky,* 946 F.2d 1516 (10th Cir. 1991).

exemption because they can be used to protect any kind of property whatsoever. *In re Goswami,* 304 B.R. 386, 390 (9th Cir. BAP 2003). The wild card exemption, as in effect at the Petition Date, permits the exemption of $925 plus any unused portion of the $17,425 homestead exemption afforded by CCP § 703.140(b)(1). The unused portion of the homestead exemption is commonly referred to as the "spillover." 2 David G. Epstein, Steve H. Nickles and James J. White, *Bankruptcy Practitioner Treatise Series* at § 8-20 (West 1992). Congress noted that the availability of the wild card exemption – and particularly the spillover component – was very important "in order not to discriminate against the nonhomeowner." H.R. Rep. No. 95-595 at 361.

Because of the spillover component, the wild card exemption is often the most significant exemption afforded to a non-homeowner debtor. This is clearly the case under the facts at hand. Debtor does not own a home, so he cannot otherwise benefit from the homestead exemption. For Debtor, the wild card exemption – and his claim of exemption as to his tax refunds in particular – is the only significant source of funds "to provide him with the basic necessities of life" as Congress recognized exemptions were designed to do. H.R. Rep. No. 95-595 at 126. Debtor's exempted federal and state income tax refunds total $10,069. The combined value of all other items that Debtor has exempted – which includes household furnishings, clothing, a 1987 Jeep Cherokee and $400 in a checking account – is only $1,700. Without his

income tax refunds, the balance of the exempt funds left to Debtor would represent roughly half of one month's living expenses for Debtor and his family.

B. Effect of IRS's Failure to Object to Exemptions

Bankruptcy Code § 522(l) provides the following procedures for claiming exemptions and objecting to claimed exemptions:

> The debtor shall file a list of property that the debtor claims as exempt under subsection (b) of this section. . . . Unless a party in interest objects, the property claimed as exempt on such list is exempt.

Federal Rule of Bankruptcy Procedure 4003(b), in turn, provides in pertinent part as follows:

> A party in interest may file an objection to the list of property claimed as exempt only within 30 days after the meeting of creditors held under § 341(a) is concluded or within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later. The court may, for cause, extend the time for filing objections if, before the time to object expires, a party in interest files a request for an extension.

The Supreme Court has directed that this 30-day limit for objections to exemptions must be strictly applied. *Taylor v. Freeland & Kronz,* 503 U.S. 638, 112 S.Ct. 1644, 118 L.Ed.2d 280 (1992).

In *Taylor*, the debtor disclosed an employment discrimination lawsuit in her schedules, listed its value as "unknown," and claimed the expected proceeds as exempt. *Id.* at 640. While the Chapter 7 trustee wrote a letter to the debtor telling her he considered the potential proceeds of the lawsuit to be property of the bankruptcy estate, he decided not to object to the claimed exemption, incorrectly assuming that the case would likely "wind up settling far within the exemption limitation." *Id.* at 641. After the debtor settled the lawsuit for $110,000, the Chapter 7 Trustee objected to the debtor's exemption. *Id.*

The trustee made three principal arguments in support of his untimely objection to the exemption of the lawsuit: (1) § 522(l) and Rule 4003(b) "serve only to narrow judicial inquiry into the validity of an exemption after 30 days, not to preclude judicial inquiry altogether";[29] (2) barring his objection as untimely would create improper incentives for a debtor to claim meritless exemptions on the chance that no party will object, thereby making his claimed exemptions valid;[30] and (3) requiring debtors to file exemptions in good faith would eliminate this otherwise improper incentive.[31]

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[29] *Taylor*, 503 U.S. at 643.

[30] The Eighth Circuit described the practice as "exemption by declaration." *In re Peterson*, 920 F.2d 1389, 1393 (8th Cir. 1990), *abrogated by Taylor*, 503 U.S. 638.

[31] *Taylor*, 503 U.S. at 644. Prior to *Taylor*, this broad "good faith" review of exemptions had been adopted by the Fifth, Sixth

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The Supreme Court rejected all of the trustee's arguments and held that he could not contest the validity of an exemption after the 30-day deadline, "whether or not [the debtor] had a colorable statutory basis for claiming it." *Id.* at 644. The Supreme Court reasoned:

> Deadlines may lead to unwelcome results, but they prompt parties to act and they produce finality. In this case, despite what [debtor's counsel] repeatedly told him, [the trustee] did not object to the claimed exemption. If [the trustee] did not know the value of the potential proceeds of the lawsuit, he could have sought a hearing on the issue, see Rule 4003(c), or he could have asked the Bankruptcy Court for an extension of time to object, see Rule 4003(b). Having done neither, [the trustee] cannot now seek to deprive [the debtor and her attorneys] of the exemption.

Id. at 644. The Court noted the trustee's concerns that this ruling would provide improper incentives to debtors to claim meritless exemptions, but found that "[t]his concern . . . does not cause us to alter our interpretation of § 522(l)." *Id.* at 644. The Court noted that bad-faith claims should be limited by existing provisions in the Bankruptcy Code that impose penalties for improper conduct by debtors or their

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and Eighth Circuits. *See In re Sherk*, 918 F.2d 1170, 1174 (5th Cir. 1990); *Peterson*, 920 F.2d at 1393-94; *In re Dembs*, 757 F.2d 777, 780 (6th Cir. 1985).

attorneys.[32] The Court reasoned that to the extent these other provisions do not curtail meritless claims by debtors, "Congress may enact comparable provisions to address the difficulties that [the trustee] predicts will follow our decision" but the courts "have no authority to limit the application of § 522(l) to exemptions claimed in good faith." *Id.* at 644-45.

Here, as in *Taylor,* no party objected to the exemptions asserted by Debtor in his Amended Schedule C. This rendered the exemptions valid and unassailable under *Taylor.* The merits of Debtor's exemption claim can no longer be argued by the IRS or considered by this Court. The IRS failed to object to the claimed exemption within the applicable time period, and the IRS is, therefore, barred from challenging its validity now. *Id.* at 642.

In addition to the directive under *Taylor,* caselaw from within the Ninth Circuit also requires this result. Indeed, the Ninth Circuit itself has consistently recognized the strict application of the 30-day limit for objections to exemptions required by *Taylor. See In re Hyman,* 967 F.2d 1316, 1319 n.6 (9th Cir. 1992) ("Unless there is a timely objection from a party in interest, any property claimed as exempt by a debtor

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[32] *See, e.g.,* 11 U.S.C. § 727(a)(4)(B) (denial of discharge for presenting fraudulent claims), Fed. R. Bankr. P. 1008 (requiring filings to be signed to verify the truthfulness under penalty of perjury), Rule 9011 (authorizing sanctions for signing meritless documents), and 18 U.S.C. § 152 (imposing criminal penalties for fraud in bankruptcy cases).

– regardless of whether the claimed exemption is valid – is automatically exempt under section 522(l)."); *In re Kahan,* 28 F.3d 79, 83 (9th Cir. 1994) ("In *Taylor,* the Supreme Court held that where the trustee fails to object timely to a claimed exemption, he cannot later contest the exemption, 'whether or not [the debtor] had a colorable statutory basis for claiming it.'"); *In re Bernard,* 40 F.3d 1028, 1031 (9th Cir. 1994), *cert. denied,* 514 U.S. 1065, 115 S.Ct. 1695, 131 L.Ed.2d 559 (1995) (holding that the deadline for objections was 30 days after the conclusion of the last continued 341(a) meeting); *Preblich v. Battley,* 181 F.3d 1048, 1052 (9th Cir. 1999) (quoting *Taylor* for the proposition that "after time to file objection has run, exemption cannot be contested, 'whether or not [the debtor] had a colorable statutory basis for claiming it.'"); *In re Smith,* 235 F.3d 472, 476 (9th Cir. 2000) ("To authorize trustees to adjourn meetings indefinitely, even when it is unlikely that any subsequent meeting will in fact be called, would nullify the thirty-day requirement of Rule 4003(b), rendering the holding in *Taylor* hollow, and undermining the concerns expressed by the Supreme Court about promptness and finality."). There is, likewise, an extensive line of cases from the Ninth Circuit Bankruptcy Appellate Panel strictly and consistently applying *Taylor. In re Morgan,* 149 B.R. 147, 151 (9th Cir. BAP 1993) ("Under *Taylor,* even an exemption claim that is totally baseless will result in the property at issue being exempt if neither the trustee nor another party in interest timely objects to the exemption."); *In re Canino,* 185 B.R. 584, 595 (9th Cir. BAP 1995) ("The

bankruptcy court's broad equitable power does not enable it to carve out an exception to *Taylor's* strict construction of § 522(l) and Fed.R.Bankr.P. 4003[.]"); *In re Heintz,* 198 B.R. 581, 584 (9th Cir. BAP 1996) ("Thus, all of the property listed as exempt on the debtor's schedules became exempt even though the debtor may have had no colorable basis for claiming the exemptions."); *In re Spenler,* 212 B.R. 625, 629 (9th Cir. BAP 1997) ("*Taylor v. Freeland & Kronz,* 503 U.S. 638, 112 S.Ct. 1644, 118 L.Ed.2d 280 (1992) . . . holds that if no objection is filed within the 30-day period proscribed by Rule 4003(b) the debtor's claimed exemption is valid."); *In re Blethen,* 259 B.R. 153, 156 (9th Cir. BAP 2001) ("In this case, not only does the [Chapter 7] Trustee's policy of general continuances render F.R.B.P. 4003(b) meaningless, it is admittedly a device to avoid the holding of the Supreme Court in *Taylor.*"); *In re Clark,* 266 B.R. 163, 172 (9th Cir. BAP 2001) (*See* discussion *infra* at page 21); *In re Morgan-Busby*, 272 B.R. 257, 265 (9th Cir. BAP 2002) ("*Taylor* made it clear that the purpose for the short objection period in Rule 4003(b) is to encourage finality. *See Taylor,* 503 U.S. at 644, 112 S.Ct. 1644. Allowing a trustee to distinguish between an objection to an exemption itself and the value of the property subject to that exemption does not promote finality."). *See also In re Boyd,* 243 B.R. 756, 766 (N.D. Cal. 2000) (finding "that section 105 cannot cure the trustee's failure to file a timely objection" to debtor's exemptions).

The only case this Court has found, from all the courts within the Ninth Circuit, which provides even the slightest qualification of the strict rule of *Taylor* is *In re Clark,* 266 B.R. 163 (9th Cir. BAP 2001). In *Clark,* the debtor described property claimed as exempt as "five lots listed in qualified retirement plan[.]" *Id.* at 165. In fact, there was no such retirement plan and the property was owned by an entity other than the debtor. *Id.* at 170-71. The Ninth Circuit Bankruptcy Appellate Panel found that because the debtor's exemption claim was "ambiguous and imprecise", the subject property was not automatically exempt under *Taylor* when no timely objection was filed. *Id.* at 170-71.

Clark is not applicable to the case at hand. Debtor specified the taxable years for the refunds he exempted. While the amounts of these refunds may not have been established at the time the exemptions were made – since Debtor had not yet filed the relevant tax returns – it was clear from the list of exemptions which years' refunds Debtor was exempting. The IRS could have objected to the exemption of the tax refunds on the basis that Debtor was not entitled to a "refund" under IRC § 6402(a) – as argued in the current Motion – and the exemption was, therefore, without merit. If the IRS needed additional time to sort out whether, in accordance with its interpretation of IRC § 6402(a), Debtor was entitled to any refunds, or what the value of such refunds might be, the IRS "could have sought a hearing on the issue, see Rule 4003(c), or [it] could have asked the

Bankruptcy Court for an extension of time to object, see Rule 4003(b)." *Taylor,* 503 U.S. at 644. The IRS had, in fact, been active in Debtor's case, and had filed an objection to confirmation of the Original Plan on the basis of Debtor's failure to file his tax returns and provide for payment in full of the IRS's priority claims. The IRS certainly was aware that Debtor had failed to file tax returns for the years 1999-2004. The IRS could have objected to Debtor's claimed exemptions on that basis alone. For whatever reason, the IRS chose not to object to the exemption of the tax refunds. Under *Taylor,* as well as the many cases from within the Ninth Circuit following *Taylor's* strict application of Rule 4003(b), the tax refunds are exempt and can no longer be subject to the IRS's subsequent efforts to assert a claim of setoff.

C. Caselaw Cited by the Parties

While the Court is compelled by *Taylor* to deny the IRS's Motion on the basis of the IRS's failure to object timely to the exemption of the refunds, neither party addresses the impact of *Taylor.*[33] Instead, the arguments presented by Debtor and the IRS highlight a conflict of authority relating to the interplay of setoff under § 553 and exemption under § 522.

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[33] In oral arguments, Debtor's counsel did raise the 30-day period for objections to exemptions under Bankruptcy Rule 4003(b), but not *Taylor* specifically. The Court brought *Taylor* to the attention of the parties at the January 31, 2007 hearing on the Motion.

Debtor's claim of exemption and the IRS's claim of setoff – both significant and compelling in their own right – appear to conflict such that both cannot be given simultaneous effect. This conflict has been noted by the Ninth Circuit BAP:

> When Section 522(c) is viewed against Section 553, we see that they present us with apparently conflicting provisions. Section 553 allows setoff of mutual debts owed between a creditor and the debtor which arose before the commencement of the case. Yet Section 522(c) bars exempt property from being liable for any debt, with certain enumerated exceptions, that arose before commencement of the case.

Pieri, 86 B.R. at 212.

In this Motion, the parties discuss cases that are part of a larger body of caselaw, from which three, very different, lines of reasoning have developed. This Court could not find, and the parties have not provided any citations for, any controlling caselaw relating to the interplay of §§ 522 and 553 under the specific facts presented. Several courts outside the Ninth Circuit have considered the IRS's ability to set off tax refunds in light of a bankruptcy debtor's claim of exemption with respect to such tax refunds. From those decisions, the three-way split of authority has developed. One line of cases holds setoff cannot be made against assets exempted under § 522 on the basis that to do so would nullify the purpose of § 522, which is to protect a minimal amount of assets

necessary to assure a fresh start for the debtor. A second line of cases holds that setoff rights under § 553 always prevail over an exemption under § 522 relying on those courts' reading of various sections of the Bankruptcy Code. Finally, a third line of cases has argued, as the IRS has done in this Motion, that a debtor's estate has no interest in any tax "overpayment" – and, therefore, the debtor cannot claim any amount as exempt – until the IRS has determined that a refund is owing after "netting" the tax liabilities pursuant to IRC § 6402(a).

1. Cases Allowing Exemption Over Setoff

As noted above, a significant line of cases has held that a debtor's claim of exemption under § 522 trumps the IRS's right of setoff under § 553. *In re Sharp,* 286 B.R. 627, 629 (Bankr. E.D. Ky. 2002); *In re Pace,* 257 B.R. 918, 920 (Bankr. W.D. Mo. 2000); *In re Jones,* 230 B.R. 875, 880 (M.D. Ala. 1999); *In re Alexander,* 225 B.R. 145, 149 (Bankr. W.D. Ky. 1998); *In re Monteith,* 23 B.R. 601, 603 (Bankr. N.D. Ohio 1982); *In re Tubbs,* No. 99-33506-PB7, 2000 WL 1203508, at *1 (Bankr. S.D. Cal. 2000) ("[T]o the extent the debtors' pre-petition tax liabilities are dischargeable, the IRS's right to setoff does not trump the debtors right of exemption").[34] *Alexander* explains the reasoning behind this approach as follows:

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[34] Outside the context of a tax liability, many other cases have also found that exemptions under § 522 trump setoff under

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> If the rule were otherwise, § 522(c) would simply have no meaning. [citations omitted] A debtor would completely lose the ability to exempt property from the reach of creditors possessing a right of offset under § 553. [citations omitted] It is a basic tenet of statutory construction that 'when two provisions of a statute are in conflict they should be interpreted in such a fashion as to give meaning to the whole.' [*In re Miel*, 134 B.R. 229, 235 (Bankr. W.D. Mich. 1991); *In re Monteith*, 23 B.R. 601, 603 (Bankr. N.D. Ohio 1982).] Thus, where one construction of a statute will nullify a provision of that statute, while an equally plausible construction will give effect to the statute as a whole, the latter construction is preferred. [citations omitted] In this case, if § 553 and § 522 are construed so as to allow the IRS to exercise its right of setoff against the Debtor's exempt property, § 522(c) will be rendered without effect or meaning. On the other hand, construing the provisions to mean that a right of set-off under § 553 is limited to property not claimed

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§ 553. *See In re Tarbuck*, 318 B.R. 78 (Bankr. W.D. Pa. 2004) (bank could not set off deficiency judgment against funds in bank account that the debtor claimed as exempt); *In re Killen*, 249 B.R. 585 (Bankr. D. Conn. 2000) (debtor's claim of exemption in her tax refund precluded government from setting debtor's refund off against her dischargeable, pre-petition debt to the Department of Housing and Urban Development); *In re Haffner*, 12 B.R. 371 (Bankr. M.D. Tenn. 1981) (bank not entitled to setoff against certificate of deposit claimed by debtor as exempt).

> exempt under § 522, gives effect to both provisions.

Alexander, 225 B.R. at 149.

In addition to the statutory construction argument noted above, these cases also emphasize that favoring exemptions over setoff rights furthers the chief policy behind the Bankruptcy Code - providing the debtor with a fresh start. *Pace*, 257 B.R. at 920, *Jones*, 230 B.R. at 880, *Alexander*, 225 B.R. at 149.

Finally, these cases hold that the legislative history of § 522 supports their position. One of the versions of § 522(c) considered by Congress, but which was never enacted, would have allowed the IRS to set off tax debts against tax refunds a debtor claimed as exempt.[35] By rejecting that version of

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[35] In relevant part, the legislative history from the report of the Senate Judiciary committee on Senate Bill 2266, which was *not* ultimately passes [sic], states:

> Subsection (c)(3) permits the collection of dischargeable taxes from exempt assets. Only assets exempted from levy under Section 6334 of the Internal Revenue Code or under applicable state or local tax law cannot be applied to satisfy these tax claims. This rule applies to pre-petition tax claims against the debtor regardless of whether the claims do or do not receive priority and whether they are dischargeable or nondischargeable. Thus, even if a tax is dischargeable vis-a-vis the debtor's after-acquired assets, it may nevertheless be collectible from exempt property held by the estate.

S. Rep. No. 95-989, 95th Cong.2nd Sess. at 76 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5862.

§ 522(c), "Congress did not intend that exempt property be liable to the payment of dischargeable tax debts, whether by set-off or otherwise." *Monteith,* 23 B.R. at 604; *see also Jones,* 230 B.R. at 880-81; *Alexander,* 225 B.R. at 150. This position, that exemptions trump setoff rights, has been identified by many courts as the "majority rule" on the issue of whether § 553 must yield to § 522. *Pace,* 257 B.R. at 920; *Jones,* 230 B.R. at 879; *Alexander,* 225 B.R. at 149.

2. Cases Allowing Setoff Over a Claimed Exemption

While it may have been the "majority" view that exemptions should prevail over a claim of setoff by the IRS, several cases have found the opposite.[36] This second line of cases holds that § 553 can only be given effect if exemptions remain subject to setoff. *IRS v. White,* 365 B.R. 457 (M.D. Pa. 2007); *United States v. Luongo,* 255 B.R. 424 (N.D. Tex. 2000), *aff'd on different grounds,* 259 F.3d 323 (5th Cir. 2001); *In re Martinez,* 258 B.R. 364 (Bankr. W.D. Tex. 2000); *In re Glenn,* 2000 WL 33364195 (Bankr. W.D. Wis. 2000); *Posey v. IRS,* 156 B.R. 910 (W.D. N.Y. 1993); *In re Eggemeyer,* 75 B.R. 20 (Bankr. S.D. Ill. 1987).[37] In

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[36] *In re Pigott,* 330 B.R. 797, 799 (Bankr. S.D. Ala. 2005) notes this was considered the majority view, "at least until 2001", when *IRS v. Luongo,* 259 F.3d 323 (5th Cir. 2001) and *In re Bourne,* 262 B.R. 745 (Bankr. E.D. Tenn. 2001) were issued.

[37] Outside the tax liability context, *see also In re Junio,* 2002 WL 32001412 (E.D. N.Y. 2002) (allowing bank to set off

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rejecting the position taken by the majority of cases favoring exemption over setoff, the *Bourne* court explained this second line of reasoning as follows:

> This court disagrees with the majority's conclusion that allowing exemption rights under § 522(c) to supersede a creditor's setoff rights under § 553 gives effect to both provisions and prevents the nullification of § 522(c). To the contrary, by giving primary effect to the exemption rights of a debtor, the offset right of a creditor is often completely nullified, as would be the result in the instant case. It is just as logical to give effect to both provisions by holding that a debtor may claim an exemption which is valid as to all creditors except one having a right of offset.

In re Bourne, 262 B.R. 745, 756 (Bankr. E.D. Tenn. 2001). This approach holds that a debtor can still exempt property under § 522 from the reach of all other creditors – just not those holding a valid right of setoff. *In re Wiegand,* 199 B.R. 639, 642 (W.D. Mich. 1996). These cases point to the language of § 553 – specifically, that "this title does not affect any right of a creditor to offset a mutual debt" – and argue that it is clear and unambiguous.

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checking account funds against loan balance claimed as exempt); *Bourne,* 262 B.R. 745 (allowing setoff of debt owed to HUD against tax refund claimed as exempt); *In re Wiegand,* 199 B.R. 639 (W.D. Mich. 1996) (allowing credit union to set off debt against debtor's credit union account claimed as exempt).

In further support of their interpretation of the Congressional intent with respect to a creditor's right of setoff, some of these cases[38] cite the language of § 542(b) regarding turnover of property of the estate which provides:

> Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.*

11 U.S.C. § 542(b) (emphasis added). The courts in these cases read this provision as unequivocally allowing any creditor with a right of setoff to retain the property – even if the debtor properly exempted the property.[39]

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[38] *White*, 365 B.R. at 462, *citing Eggemeyer*, 75 B.R. at 22, *Posey*, 156 B.R. 910, *Wiegand*, 199 B.R. at 643 and *Bourne*, 262 B.R. at 754.

[39] This cannot be an accurate interpretation of 542(b) since creditors do not have an absolute right to retain property just because they assert a right of setoff. As noted by the Ninth Circuit BAP in *Pieri*, for example, California state law does not allow setoff against exemptions that are designed to ensure payment of daily living expenses, such as wages and unemployment or disability benefits. *Pieri*, 86 B.R. at 210-11. *See also* footnote 51, *infra*. Further, within the Ninth Circuit, it is well settled that the allowance or disallowance of a setoff is ultimately within the discretion of the trial court. *Cascade Roads*, 34 F.3d at 763. *Accord* 5 Collier on Bankruptcy ¶ 553.02[3] (15th

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In response to this argument, the pro-exemption cases have countered that § 542(b) does not apply to property that has been exempted by the debtor because it is no longer "property of the estate." *Jones*, 230 B.R. at 881-82; *Alexander*, 225 B.R. at 150-51. "In this case, the IRS simply does not have a valid right of setoff. Debtor has properly exempted his tax refund; consequently, the refund is no longer property of the estate. Rather, it is property belonging to Debtor." *Alexander*, 225 B.R. at 151 (citations omitted). Such property is then subject to turnover pursuant only to § 542(a), which requires an entity that possesses property that the debtor may exempt, to deliver such property to the trustee. *Bourne*, 262 B.R. at 755. Section 542(a) does not contain an express exception for a creditor with a right to set off.

Pro-setoff cases respond that a debtor's claim to a refund is a "debt" owed to the debtor by the IRS, rather than funds belonging to the debtor. Accordingly, any turnover request is covered by § 542(b), not § 542(a), and is therefore subject to setoff rights, as preserved by § 553. *Bourne*, 262 B.R. at 756.

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ed. rev. 2003); *Bohack Corp. v. Borden, Inc.* (*In re Bohack, Corp.*), 599 F.2d 1160, 1165 (2d Cir. 1979); *U.S. v. Norton*, 717 F.2d 767, 772 (3d Cir. 1983); *Cohen v. Savings Bldg. & Loan Co.* (*In re Bevill, Bresler & Schulman Asset Management Corp.*), 896 F.2d 54, 57 (3d Cir. 1990); *DuVoisin v. Foster* (*In re Southern Indus. Banking Corp.*), 809 F.2d 329, 332 (6th Cir. 1987); *In re Myers*, 362 F.3d 667, 672 (10th Cir. 2004); *Dayton Sec. Assocs. v. Securities Group 1980* (*In re The Sec. Group 1980*), 74 F.3d 1103, 1114 (11th Cir. 1996).

This debate is somewhat circuitous. If a court assumes a tax refund can be exempted, then § 542(a) is the applicable provision. If, however, the court starts with the assumption that a mere right of setoff (as distinguished from the situation where the creditor has already exercised a setoff before the debtor exempted the property) prevents a claim of exemption, then § 542(b) would control. The Court finds that this debate is not supportive of either position at least when, as here, there is both property that has already been fully exempted, and a subsequent claim of setoff as to the same property. Only after the court determines whether setoff or exemption should prevail is the question resolved of whether § 542(a) or § 542(b) is triggered.

In response to the "fresh start" policy argument raised in favor of exemptions, some decisions favoring setoff note that "this policy is not always paramount and is often subordinated to other social and economic concerns and objectives." *Bourne,* 262 B.R. at 757. These countervailing objectives include the common law rights of creditors to set off mutual debts. *Martinez,* 258 B.R. at 367. The pro-setoff cases argue that not upholding setoff rights in bankruptcy would provide incentives to creditors to set off debts earlier, rather than risking the loss of the setoff right in a later bankruptcy. Recognition of the setoff right "removes an incentive that might otherwise lead a creditor to take precipitous action." *Bourne,* 262 B.R.

at 758, *quoting,* 5 *Collier on Bankruptcy* ¶ 553.02[2] (15th ed. rev. 2000).[40]

In response to the arguments offered by the pro-exemption cases relating to the legislative history of § 522(c), the pro-setoff cases counter:

> [T]he conclusion that exempt property is not liable for discharged taxes does not necessarily preclude offset against property claimed exempt. As the *Wiegand* court recognized, there is a distinction between collecting on a unilateral debt and offsetting a mutual obligation. *In re Wiegand,* 199 B.R. at 642. The majority courts relying on legislative history may have been persuaded by the fact that the IRS was seeking an offset against the debtor's discharged tax liability. *See In re Jones,* 230 B.R. at 876; *In re Alexander,* 225 B.R. at 147; *In re Monteith,* 23 B.R. at 602. If debts other than tax obligations had been involved, the legislative history would have provided no basis for denial of offset.

In re Bourne, 262 B.R. at 757. Stated another way, just because Congress chose not to permit the collection of dischargeable taxes from exempt assets – as was proposed in the Senate's version of § 522(c) –

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[40] 5 *Collier on Bankruptcy* ¶ 553.02[2], as quoted by *Bourne,* discusses the policy reasons for the preservation of rights of setoff under § 553. This section of *Collier* does not address the interplay between §§ 522 and 553 or even mention exemptions under § 522.

does not necessarily mean that that decision by Congress was meant to address the interplay of exemptions under § 522 and setoff under § 553. The pro-setoff cases argue that the legislative history at issue only dealt with the issue of exemptions standing alone, not in combination with § 553.

3. Cases Allowing "Netting" of Liabilities by the IRS

A third, distinct line of reasoning has gained support in the last few years. These cases draw a clear distinction between a tax "overpayment" and a tax "refund." They hold that a debtor's estate has no interest in any tax overpayment until the IRS has determined that a refund is owing after "netting" the tax liabilities pursuant to IRC § 6402(a).[41] If the estate has no interest in a tax overpayment until after the IRS's netting, then the debtor cannot even claim the overpayment/refund as exempt. Therefore, under this third line of reasoning, a claim of

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[41] *Pettibone Corp. v. United States,* 34 F.3d 536 (7th Cir. 1994); *United States v. Midway Indus. Contractors, Inc.* (*In re Midway Indus. Contractors, Inc.*), 178 B.R. 734, 737 (N.D. Ill. 1995) (IRS did not violate the automatic stay when it offset a tax liability against a tax refund on the ground that "netting" of the obligation was not a "setoff" within the meaning of the Code); *Lyle v. Santa Clara Co. Dept. of Child Support* (*In re Lyle*), 324 B.R. 128, 131-32 (Bankr. N.D. Cal. 2005); *Security Pac. Nat'l Bank v. U.S.* (*In re Siebert Trailers*), 132 B.R. 37, 40 (Bankr. E.D. Cal. 1991); *IRS v. Luongo* (*In re Luongo*), 259 F.3d 323, 335 (5th Cir. 2001).

exemption by a debtor with respect to an anticipated tax "refund" does not preclude the IRS from offsetting pre-petition tax liabilities against such pre-petition "overpayment."[42]

The case most cited as supporting this "netting" argument is the Fifth Circuit's decision in *In re Luongo,* 259 F.3d 323, 335 (5th Cir. 2001). In *Luongo,* after a discharge had been entered in favor of a Chapter 7 debtor and her bankruptcy case had been closed, the IRS set off the debtor's discharged pre-petition income tax liability for 1993 against a pre-petition tax refund owing to the debtor for 1997. The debtor then reopened her bankruptcy case, filed amended schedules listing the tax refund as exempt, and brought an adversary proceeding to compel turnover of the 1997 refund. Both the debtor and the IRS brought motions for summary judgment on the debtor's turnover action. The Bankruptcy Court granted the debtor's motion, specifically adopting the pro-exemption reasoning of *Alexander,* 225 B.R. 145. *U.S. v. Luongo,* 255 B.R. 424, 427 (N.D. Tex. 2000). The IRS appealed this decision to the District Court. The District Court reversed the Bankruptcy Court's decision, and granted the IRS's cross-motion for

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[42] This reasoning is contrary to the well-established principles that property of the estate, which may be exempted by a debtor, includes: (1) contingent and/or unliquidated claims held by the debtor; and, more specifically, (2) unliquidated tax refunds for pre-petition taxable years. *See* footnotes 27 and 28 *supra.*

summary judgment, following the pro-setoff line of cases noted above and holding that the "clear and unambiguous language of § 553(a)" dictates that "the IRS's right of setoff is unaffected by Luongo's claims that (1) the tax refund is exempt property and (2) that the tax liability was discharged in the bankruptcy proceeding." *Luongo,* 255 B.R. at 427-28. The debtor then appealed to the Fifth Circuit. The Fifth Circuit affirmed the District Court's decision, but on very different grounds.

While both the District Court and the Fifth Circuit in *Luongo* came down in favor of the IRS, the Fifth Circuit rejected the pro-setoff reasoning adopted by the District Court and, instead, relied upon the "netting" provisions of IRC § 6402(a). Specifically, the Fifth Circuit held:

> A debtor's claim to a tax refund is property of the estate. *Mueller v. Commissioner,* 496 F.2d 899, 903 (5th Cir. 1974). However, under 26 U.S.C. § 6402(a) the debtor is generally only entitled to a tax refund to the extent that her overpayment exceeds her unpaid tax liability. . . . Section 6402(a) grants the IRS discretion whether to offset against a debtor's unpaid tax liability or to refund the overpayment to the taxpayer. The IRS elected to exercise that discretion to apply the overpayment to Appellant's past liability. Because the prior unpaid tax liability exceeded the amount of the overpayment, the debtor was not entitled to a refund and the tax refund did not become property of the estate.

> Absent an interest in the estate to the refund, it could not properly be exempted by the debtor under § 522.

Luongo, 259 F.3d at 335. The unusual, but crucial, factual circumstance in *Luongo,* is that the IRS set off the pre-petition tax liability against the pre-petition tax refund ***before*** the debtor reopened her bankruptcy case and amended her Schedules to claim the tax refund as exempt. The Fifth Circuit held that because the IRS had elected to set off the tax liability, there was no longer a balance to be refunded to the debtor. If no refund existed after the setoff, then it could not have become property of the estate and could not have been properly exempted by the debtor. Because the debtor "could not properly exempt the overpayment at issue", the Fifth Circuit did "not reach the exemption issue decided below – that is, whether § 522(c) prevents a creditor from exercising its right to setoff preserved in § 553." *Id.* at 328. Therefore, the balance of the Fifth Circuit's opinion in *Luongo* relating to the netting argument is reduced to *dicta. Luongo* stands for the simple proposition that when a setoff occurs prior to the exemption, there is nothing left to exempt – not that the IRS has some superior right to exempt funds through netting under IRC § 6402. Unlike in the present case, *Taylor* was not controlling in *Luongo* since the setoff occurred prior the claim of exemption.

It is important to note that *Luongo* arose in the context of a motion by the debtor to compel the turnover of a tax refund which had been set off by the IRS

before the debtor reopened her bankruptcy case. *Luongo,* and its discussion of the netting argument, would not support a motion for relief from stay – as is currently pending before this Court. In *Luongo,* the IRS did not need relief from stay to offset the tax liability against the tax refund, because the debtor's bankruptcy case was closed at the time of the setoff.

The problem is that several, more recent decisions have taken the Fifth Circuit's discussion of netting under IRC § 6402 out of context and have ignored the unique fact that, in *Luongo,* the netting occurred prior to the claim of exemption by the debtor. In some instances, these newer decisions have used the Fifth Circuit discussion of netting under IRC § 6402(a) to validate post-petition setoffs by the IRS.[43]

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[43] *In re Lyle,* 324 B.R. 128 (Bankr. N.D. Cal. 2005) (denying Chapter 13 debtor's motion to compel turnover of tax refunds and for damages for violation of the automatic stay resulting from IRS's setoff of pre-petition support obligations against anticipated pre-petition tax refund pursuant to IRC § 6402(c)); *In re Baucom,* 339 B.R. 504, 507 (Bankr. W.D. Mo. 2006) (denying debtor's motion to reopen case and compel turnover of tax refund against which IRS offset debt owed to Rural Housing Department); *Beaucage v. IRS,* 342 B.R. 408, 411 (D.Mass.2006) (dismissing adversary proceeding challenging post-petition setoff of tax liability); *In re Jones,* 359 B.R. 837, 841 (Bankr. M.D. Ga. 2006) (granting summary judgment in favor of IRS in adversary brought by debtor to recover anticipated tax refunds against which IRS set off pre-petition tax liability); *In re Shortt,* 277 B.R. 683, 692 (Bankr. N.D. Tex. 2002) (annulling stay to validate setoff of pre-petition debt owed to Army and Air Force Exchange Service against tax refund under IRC § 6402(d)); *In re Pigott,* 330 B.R. 797, 800 (Bankr. S.D. Ala. 2005) (upholding objection

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Following the reasoning of these cases, since IRC § 6402 defines whether a refund exists, the IRS may set off debts – pre-petition or post-petition – and thereby remove a potential refund from the property of the estate.[44] Some of these cases have used the Fifth Circuit's *Luongo* decision as a basis for granting relief from stay in favor of the Federal government to effectuate a post-petition setoff pursuant to IRC § 6402, even after the tax refund in question had been fully exempted by the debtors. *See, e.g., Shortt,* 277 B.R. 683.

However, this is a complete misapplication of *Luongo. Luongo* does not stand for the proposition that the IRS has an absolute right to set off pursuant to IRC § 6402(a) at anytime. Rather, *Luongo* held that where the IRS ***has*** properly exercised its setoff – outside the pendency of the bankruptcy case – there no longer is a "refund" which may, thereafter, become property of the estate. This Court agrees with *Luongo* on this point. As noted above, the Fifth Circuit's decision in *Luongo* specifically states that it did "not reach the exemption issue decided below – that is, whether § 522(c) prevents a creditor from exercising its right of setoff preserved in § 553." *Luongo,* 259 F.3d at 328. Therefore, it is inaccurate for these more recent cases to cite the Fifth Circuit's decision in

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by IRS to Chapter 7 debtor's claim of exemption as to anticipated refund).

[44] *See Lyle,* 324 B.R. 128; *Pigott,* 330 B.R. 797; *Shortt,* 277 B.R. 683.

Luongo as authority for the proposition that, because of the netting allowed by IRC § 6402(a), the IRS's setoff claim under § 553 trumps an exemption asserted by the debtor, without opposition, under § 522.

Although the netting argument has been frequently cited favorably in recent setoff cases, as if it represented a new, important insight on the setoff issue, it is not at all new. Long before *Luongo* and the later cases which greatly expanded the netting argument, the Seventh Circuit espoused the netting theory in *Pettibone Corp. v. United States,* 34 F.3d 536 (7th Cir. 1994). *Pettibone* even went so far as to suggest in *dicta* that netting of pre-petition tax liabilities by the IRS does not constitute a "setoff" within the meaning of Bankruptcy Code and, therefore, the IRS would not be subject either to the automatic stay under § 362 or the requirements for setoff under § 553.[45] This position was then interpreted as the holding of *Pettibone* by many courts and *Pettibone* was cited as authority for the position that "no setoff [occurs] when the IRS [nets] the debtor's underpayments and overpayments in arriving at the amount of the debtor's refund." *United States v. Midway Indus. Contractors, Inc.* (*In re Midway*), 178 B.R. 734, 737 (N.D. Ill. 1995). Unlike the more recent netting cases,

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[45] After explicitly setting forth this position, the *Pettibone* court then said it did not reach the issue of whether the IRS's setoff "would have been permissible as a setoff under the Bankruptcy Code[,]" because the plan permitted the setoff. *Pettibone,* 34 F.3d at 539-40.

however, *Pettibone* and the litany of cases that followed it did not deal with a conflict between §§ 522 and 553 – *Pettibone* solely addressed the issue of setoff by the IRS.

Pettibone's proposition that netting by the IRS does not constitute a setoff under § 553 is echoed in the reasoning of the more recent pro-setoff cases, which hold that this netting removes the refund from the property of the estate. If IRC § 6402 simply defines whether a refund exists, as these recent cases argue, the post-petition netting of pre-petition tax liabilities would not constitute a "setoff" within the meaning of the Bankruptcy Code. If refunds do not become property of the estate unless there are funds left after the IRS nets liabilities – assuming, of course, the IRS chooses to do so under IRC § 6402(a)[46] – then there would be no need for the IRS to seek relief from stay to effectuate such a netting. The IRS would not be taking any action against property of the estate since, per this line of reasoning, there is no refund to be property of the estate.

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[46] The setoff of tax liabilities against tax refunds under IRC § 6402(a) is discretionary. Setoffs for other types of debts are governed by other sections of § 6402 – past due support obligations are governed by § 6402(c), obligations to other federal agencies are governed by § 6402(d) and obligations on state income tax are governed by 6402(e). The setoffs under §§ 6402(c), (d) and (e) are mandatory in nature, not at the discretion of the IRS.

After *Pettibone,* several other courts rejected the notion that the IRS's netting under IRC § 6402 does *not* constitute a setoff within the meaning of the Bankruptcy Code, thereby eliminating the need for the IRS to seek relief from stay. Rather, those courts specifically held that the IRS ***did*** need relief from stay to allow a setoff in order to net refunds owed by the IRS against taxes owed by the taxpayer. The predominant case rejecting *Pettibone* and the netting argument is the Second Circuit's decision in *Aetna Casualty and Surety Co. v. LTV Steel Co., Inc.* (*In re Chateaugay Corp.*), 94 F.3d 772, 780-82 (2d Cir. 1996).[47] *Chateaugay* unequivocally held that the

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[47] *See also* 5 *Collier on Bankruptcy,* ¶ 553.06[3][b] (15th ed. rev. 2007), fn. 26, *citing United States v. Norton,* 717 F.2d 767, 772, 9 C.B.C.2d 336, 344 (3d Cir. 1983); *United States v. Reynolds,* 764 F.2d 1004, 1006-1007 (4th Cir. 1985); *United States v. Johnson* (*In re Johnson*), 136 B.R. 306, 308-11 (Bankr. M.D. Ga. 1991); *In re Hackney,* 20 B.R. 158, 159 (Bankr. D. Idaho 1982); *Rozel Indus., Inc. v. Internal Revenue Serv.* (*In re Rozel Indus., Inc.*), 120 B.R. 944, 948 (Bankr. N.D. Ill. 1990); *In re Franklin Sav. Corp.,* 177 B.R. 356, 359-60 (Bankr. D. Kan. 1995); *In re Academy Answering Servs., Inc.,* 20 C.B.C.2d 174, 177-78, 90 B.R. 294, 295-96 (Bankr. N.D. Ohio 1988); *rev'd* on other grounds, 100 B.R. 327 (N.D. Ohio 1989); *United States v. Perry* (*In re Perry*), 26 B.R. 599, 600 (Bankr. E.D.Pa.1983); *In re Internal Revenue Service Liab. & Refunds,* 10 C.B.C.2d 609, 611, 30 B.R. 811, 812-14 (M.D. Tenn. 1983) (vacating as violating the automatic stay and the strictures of section 553 an agreed order that would have permitted IRS to exercise its Section 6402(a) setoff procedures in every chapter 13 reorganization case in the district without further judicial inquiry); *Runnels v. I.R.S.* (*In re Runnels*), 134 B.R. 562, 564-65 (Bankr. E.D. Tex. 1991); *In re Burrow,* 36 B.R. 960, 963 (Bankr. D. Utah 1984).

"netting" of an "overpayment" to extinguish an "underpayment" is a classic setoff within the meaning of the Bankruptcy Code. Therefore, the IRS, like any other creditor with a setoff right that has not yet been exercised, is subject to the provisions of §§ 362 and 553. The *Chateaugay* court held:

> By arguing that the "accounting" procedure under 6402(a) is something other than an ordinary right of setoff, the government in essence asks us to find that the bankruptcy laws do not apply to the IRS. This we cannot do. For the Supreme Court has quite clearly held that "[n]othing in the Bankruptcy Code or its legislative history indicates that Congress intended a special exception for the tax collector." *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 209, 103 S.Ct. 2309, 2316, 76 L.Ed.2d 515 (1983); see also *United States ex rel. IRS v. Norton*, 717 F.2d 767, 772 (3d Cir. 1983).

Chateaugay, 94 F.3d at 780-81.[48]

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[48] Indeed, even the IRS has interpreted a setoff under IRC § 6402(a) as a "collection activity" and not merely an accounting procedure. *See Hall v. Commissioner of Internal Revenue*, 2004 WL 1616382, at *2 (U.S. Tax Ct. 2004), *citing Campbell v. Commissioner*, 121 T.C. 290, 292, 2003 WL 22765712 (2003) and secs. 1.6015-5(b)(2)(I), 1.6015-9, Income Tax Regs (defining an offset of an overpayment against a liability pursuant to section 6402 as a collection activity effective for requests for relief from joint and several liability filed on or after July 18, 2002).

This Court finds *Chateaugay* much more persuasive and better reasoned than *Pettibone*. The problems noted in *Chateaugay* with the netting approach, as set forth in the above quote, are well taken. The setoff sought by the IRS is not unlike the setoff by any other creditor. The tax refunds in dispute ceased being property of the estate when Debtor exempted them, without opposition by the IRS. *Taylor,* 503 U.S. 638. At that point, the exempt tax refunds were no longer subject to any possible setoff against debts owed by the estate.

4. Analysis of Three Lines of Cases

The interplay between §§ 522 and 553 is clearly a difficult issue. While the three lines of cases noted above provide extensive justifications for the decisions reached, the strict application of any of these three lines of reasoning is problematic. To adopt the stringent reading of § 553, which dictates that § 553 always trumps § 522, as advocated by decisions such as *Bourne,* would necessarily ignore the directives from within the Ninth Circuit to consider the equities presented in each case. However, adopting an approach that always favors exemption over setoff – outside of the *Taylor* failure to object context – would be equally inappropriate.

The interpretation advocated by the cases adopting the netting approach – and primarily relied upon by the IRS in its Motion – is, however, the most problematic. *Luongo,* as expressly stated by the Fifth

Circuit in its decision, does not address what should happen when the IRS seeks to set off against a refund that is already exempt. Those ***are*** the facts currently before the Court. In addition, as discussed above, *Luongo* and the netting argument clearly do not support the granting of a motion for relief from stay, which is currently before the Court in this case. Rather, the logical extension of the netting argument, as discussed in *Pettibone* and rejected in *Chateaugay,* would be that the IRS could operate entirely outside the Bankruptcy Code in netting pre-petition tax refunds against pre-petition tax liabilities, and the IRS would not need to seek relief under §§ 362 and 553.

While the BAPCPA provides that, in post-BAPCPA cases, the automatic stay does not apply to setoffs by the IRS pursuant to § 6402(a), the new § 362(b)(26) did not exist at the time this case was filed. Further, the new § 362(b)(26) recognizes that the netting of tax liabilities under IRC § 6402 is, in fact, a "setoff" within the meaning of the Bankruptcy Code – it simply provides that the automatic stay no longer applies to such setoffs. However, the new § 362(b)(26) does not address the ability of the IRS to offset pre-petition tax liabilities after a debtor has fully exempted pre-petition tax refunds. This issue was not addressed by the BAPCPA and is not presently before this Court. In the future, the conflict between §§ 522 and 553 may arise either in the context of the IRS's objection to a claim of exemption with respect to a tax refund, or in the context of a turnover

action by the debtor under § 542 – rather than, as here, in the context of a motion for relief from stay to effect a setoff. *See* footnote 22 *supra*.

The crux of the IRS's Motion is that the IRS must be granted relief from stay because there is no "refund" Debtor may exempt after the IRS's netting of the pre-petition tax debts pursuant to IRC § 6402(a). This argument rests solely upon distinction between a tax "overpayment" and a tax "refund" adopted by the cases following the netting approach. However, this Court finds this premise unworkable for largely the same reasons as expressed by the Second Circuit in *Chateaugay*.

If the netting argument is accepted, then the IRS does not need relief from stay to effectuate the "netting" under IRC § 6402(a), since, under this view, the netting merely defines whether a "refund" exists and does not constitute a setoff within the meaning of § 553. For this reason, even if the Court were to adopt the underlying basis for the Motion, *i.e.*, that there is no property of the estate until the IRS performs its netting operation, it would, nevertheless, have to deny the Motion itself. The IRS has not argued in the Motion that it can set off without relief from stay. Therefore, that issue is not properly before this Court and is not decided by this decision. The Court merely finds that *Luongo* and the decisions adopting the netting approach do not support relief from stay as requested by the Motion.

D. Alternative Holding – Balancing of Equities

If *Taylor* is not dispositive of the issue before the Court, the Court also finds, as an alternative holding, that the Motion should be denied on its merits. Perhaps contrary to the three lines of cases noted above, the Ninth Circuit directs this Court to balance the equities presented. *See FDIC v. Bank of America,* 701 F.2d at 836-37; *Cascade Roads,* 34 B.R. at 763; *Pieri,* 86 B.R. at 210. In balancing those equities, there are several important factors that weigh in Debtor's favor.

First and foremost, the IRS did not object to the exemption of the refunds by Debtor. The IRS could have easily objected to the exemption on the basis that, as the IRS well knew, Debtor had not yet filed his tax returns for 1999-2004. These tax returns were not fully filed by Debtor until roughly two months after Debtor asserted his exemptions. The IRS had been active in Debtor's case early on and had filed an objection to confirmation of the Original Plan on this very basis. As also noted above, the IRS could have objected to the exemption on the basis that Debtor was not entitled to a "refund" under IRC § 6402(a) and the exemption was, therefore, without merit.

Alternatively, the IRS could have also asked for an extension of time, pursuant to Federal Rule of Bankruptcy Procedure 4003(b), to object to the exemptions until it had an opportunity to review the late-filed tax returns for 1999-2004 and to evaluate its potential setoff claims under IRC § 6402(a). The

IRS does not argue that it was somehow prevented from filing a timely objection to the exemptions, or that to require the IRS to object to the exemptions of tax refunds by debtors would present an undue burden.

The IRS simply chose not to file an objection. Therefore, the merits of such potential objections and/or requests for an extension of time to file an objection are not properly before this Court, and this decision is not meant to address how the Court might have ruled on such objections or requests. The fact that the IRS chose not to file an objection to the exemption of the tax refunds prevented the Court from addressing any such issues in a timely manner and weighs in Debtor's favor in a substantive balancing of the equities – in addition to the dispositive effect such failure to object has under *Taylor*.

Second, IRC § 6402(a) does not confer upon the IRS any extraordinary status or rights. It is merely a provision allowing the discretionary setoff of debts owed to the IRS. Setoff is a right held by many types of creditors under various non-bankruptcy laws. Other subsections of IRC § 6402 do confer special rights and status to other governmental agency creditors, if certain additional requirements are met.[49]

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[49] IRC § 6402(c) allows for the interception of tax refunds for the payment of pay due support obligations. IRC § 6402(d) allows for the interception of tax refunds for the payment of debts owed to Federal agencies, other than the IRS. IRC

(Continued on following page)

For example, in *Lyle,* the state agency to which dependent care debts were owed intercepted the debtor's future income tax refunds, pursuant to IRC § 6402(c). Pre-petition, the state agency notified the debtor that his delinquent child support obligations would be subject to collection through the federal tax intercept program, and that if he wanted to dispute obligations he needed to contact the state agency. The debtor did not dispute the obligations. This satisfied the notice requirements of IRC 6402(c). When the tax refund was due to the debtor post-petition in *Lyle,* the IRS was already under a pre-existing statutory obligation to transfer the funds to the intercepting state agency. The IRS had no discretion to do anything else, and the Bankruptcy Court had no authority to order otherwise.[50] Here, there is no such statutorily – mandated interception in place by another governmental agency. This is simply an attempt by the IRS to exercise its discretionary ability to set off debts owed to itself. Under the facts at hand, the setoff rights of the IRS under IRC

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§ 6402(e) allows the interception of tax refunds for the payment of state income tax obligations.

[50] IRC § 6402(f), which emphasized the non-discretionary nature of the interception, provides, in pertinent part, as follows:

> No court of the United States shall have jurisdiction to hear any action, whether legal or equitable, brought to restrain or review a reduction authorized by subsection (c), (d), or (e). No such reduction shall be subject to review by the Secretary in an administrative proceeding.

§ 6402(a) are just the same as any other creditor's setoff rights and the IRS is not afforded special treatment.

Third, this discretionary right of setoff was not timely exercised by the IRS in this case. Unlike *Luongo,* the IRS had not set off the tax liabilities prior to Debtor's claim of exemption. In this case, Debtor's exemption came first and was followed several months later by the IRS's motion for relief from stay to set off.

Finally, the facts of this case relating to Debtor's financial position weigh heavily in favor of denying the IRS's claim of setoff. The Ninth Circuit has directed that setoff should not be allowed when it would be inequitable or against public policy to do so. *FDIC v. Bank of America Nat'l Trust and Savings,* 701 F.2d at 836-37.[51] The facts presented by this case do not

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[51] California state law has also protected exempt property against claims of setoff when necessary to further state policy. *See In re Ter Bush,* 273 B.R. 625, 631-32 (Bankr. S.D. Cal. 2002) (finding California state law supportive of "the proposition that exempt property will be protected from setoff when an important public policy regarding the rights of the debtor is involved, regardless of the statutory language granting the exemption."); *see also Birman v. Loeb,* 64 Cal.App.4th 502 (1998) (disallowing setoff of debt owed by debtor against non-judicial foreclosure deficiency); *Barnhill v. Robert Saunders & Co.,* 125 Cal.App.3d 1 (1981) (disallowing setoff of employee's exempt wages against debts owed to employer); *Kruger v. Wells Fargo Bank,* 11 Cal.3d 352 (1974) (disallowing setoff against debtor's bank account containing funds derived from unemployment compensation and disability benefits); *Williams v. Williams,* 8 Cal.App.3d 636

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show a debtor trying "to take unfair advantage" of an adversary by using a claim of exemption to defeat a setoff. *Pieri,* 86 B.R. at 213.[52] The record shows a debtor who has absolutely nothing else but the tax refunds in question to "provide him with the basic necessities of life." H.R. Rep. No. 95-595 at 126. Debtor's schedules show a positive monthly cash flow of only $75, which Debtor has dedicated to payments under his confirmed Amended Plan. Debtor has virtually no assets, other than his tax refunds, and he has two dependent children. Allowing the IRS to set off the tax refunds would take from Debtor his wild-card exemption – the most important exemption available to him as a nonhomeowner. This would be contrary to both the interest of bankruptcy policy and California state exemption policy.

There are factors weighing in the IRS's favor. Debtor owes pre-petition income taxes, both to the

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(1970) (disallowing setoff against alimony or child support payments).

[52] *See also In re Winnett,* 97 B.R. 7 (Bankr. E.D. Cal. 1989) (finding attorneys had superior rights to funds held in an attorney's trust account subject to a pre-petition fee dispute with the debtors notwithstanding debtors' assignment of their rights to disputed funds as a down payment for a new home and the subsequent claim of homestead exemption as to such disputed funds upon then filing bankruptcy); *In re Glaze,* 169 B.R. 956 (Bankr. D. Ariz. 1994) (allowing setoff of damages awarded by state court arising from the forced sale of debtors' home even though debtors had subsequently filed bankruptcy and asserted a homestead exemption as to the proceeds in hopes of defeating the damages award).

IRS and to the FTB.[53] Debtor failed to file tax returns for six consecutive years pre-petition. Finally, there is a presumption in favor of allowing setoffs in recognition of the long-standing common law right. *In re Hal*, 122 F.3d 851, 852 (9th Cir. 1997). However, that presumption does not withstand the countervailing equities weighing in the Debtor's favor, as discussed above, under the facts presented.

The Court notes that the IRS has argued that its setoff right gives it a secured claim under § 506(a) which provides:

> An allowed claim of a creditor . . . that is subject to setoff under section 553 of this title, is a secured claim . . . to the extent of the amount subject to setoff . . . and is an unsecured claim to the extent that . . . the amount so subject to setoff is less than the amount of such allowed claim.

Because the Court has determined that the equities weigh in favor of Debtor's exemption over the IRS's claim of setoff, § 506(a) is no longer applicable to the IRS's claim.[54] The Court is denying the IRS's claim of setoff, not merely delaying it by treating it as a secured claim under the Amended Plan. To delay,

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[53] *See* footnote 26 *supra*.

[54] Section 506(a) does not provide any additional insight as to whether setoff or exemption rights should prevail. It simply specifies the treatment of the claim once the court has determined that a setoff should be allowed under § 553.

rather than deny, setoff would be to eviscerate the purpose of this Debtor's crucial wild card exemption.[55]

Finally, the Court notes that the IRS has suggested that the Court only has the discretion to delay setoff rather than to deny it entirely. Specifically, the IRS has argued:

> [D]enying relief from stay *serves no conceivable purpose* because the Court lacks jurisdiction to order a tax refund and because Debtor is not entitled to have it turned over to him. The tax overpayments will be permanently frozen until the stay terminates or the statute of limitations for a refund claim expires.

IRS's Supp. Brief at 2:25-3:3. This argument was soundly rejected by the Ninth Circuit in *Cascade Roads,* 34 F.3d at 765-66. Further, this argument fails to recognize that it is the Court – not the IRS – that is charged with the duty of evaluating setoff claims under § 553. The caselaw is clear that it is within the Court's discretion to grant or deny a motion for relief from stay to allow a party to effectuate a setoff. *Cascade Roads,* 34 F.3d at 763; *FDIC v. Bank of America Nat'l Trust and Savings,* 701 F.2d at 836-37. The Court is not bound by the netting argument espoused by the Fifth Circuit in *Luongo,* which is the

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[55] It is not uncommon for courts to alter the "collateral" rights of tax claimants in order to preserve the debtor's exemptions. Even tax liens – an interest superior to that of the IRS's current claim – can be avoided under §§ 522(f)(1)(A) and (h).

only support for the IRS's assertion that "Debtor is not entitled to have [the tax refund] turned over to him."

IV [sic].

CONCLUSION

For the reasons set forth in this Memorandum Decision, the IRS's Motion is denied and the IRS is not permitted to offset Debtor's unpaid tax liabilities against the $6,852 owed to Debtor as tax refunds for 2002 and 2004. The Court denies the Motion on two separate bases: (1) Debtor's exemption of the tax refunds is no longer subject to challenge pursuant to *Taylor* and (2) the equities require that the IRS's setoff rights yield to Debtor's wildcard exemption on the facts of this case.

For the reasons stated above, the IRS is also not entitled to have a portion of its claim treated as a secured claim pursuant to § 506(a).

Because the Court has determined that the IRS is not entitled to set off, the IRS does not have a basis to retain the $6,852 owing to Debtor as tax refunds for 2002 and 2004. Therefore, the IRS shall promptly turn over these funds to Debtor.

Counsel for Debtor shall submit a proposed form of order after review by counsel for the IRS as to form.

Dated: June 12, 2008

/s/ Arthur S. Weissbrodt
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UNITED STATES
BANKRUPTCY JUDGE

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UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re: ANTHONY S. GOULD, Debtor, ANTHONY S. GOULD, Appellant, v. UNITED STATES OF AMERICA, Appellee, and DEVIN DERHAM-BURK, Chapter 13; UNITED STATES TRUSTEE, Trustees.	No. 09-60008 BAP No. NC-08-1100-JuMkD ORDER (Filed Jun. 22, 2010)

Before: O'SCANNLAIN, TROTT and PAEZ, Circuit Judges.

Judges O'Scannlain and Paez have voted to deny the petition for rehearing en banc and Judge Trott so recommends.

The full court has been advised of the suggestion for rehearing en banc and no judge of the court has requested a vote on it. Fed. R. App. P. 35(b). The petition for rehearing en banc is DENIED.